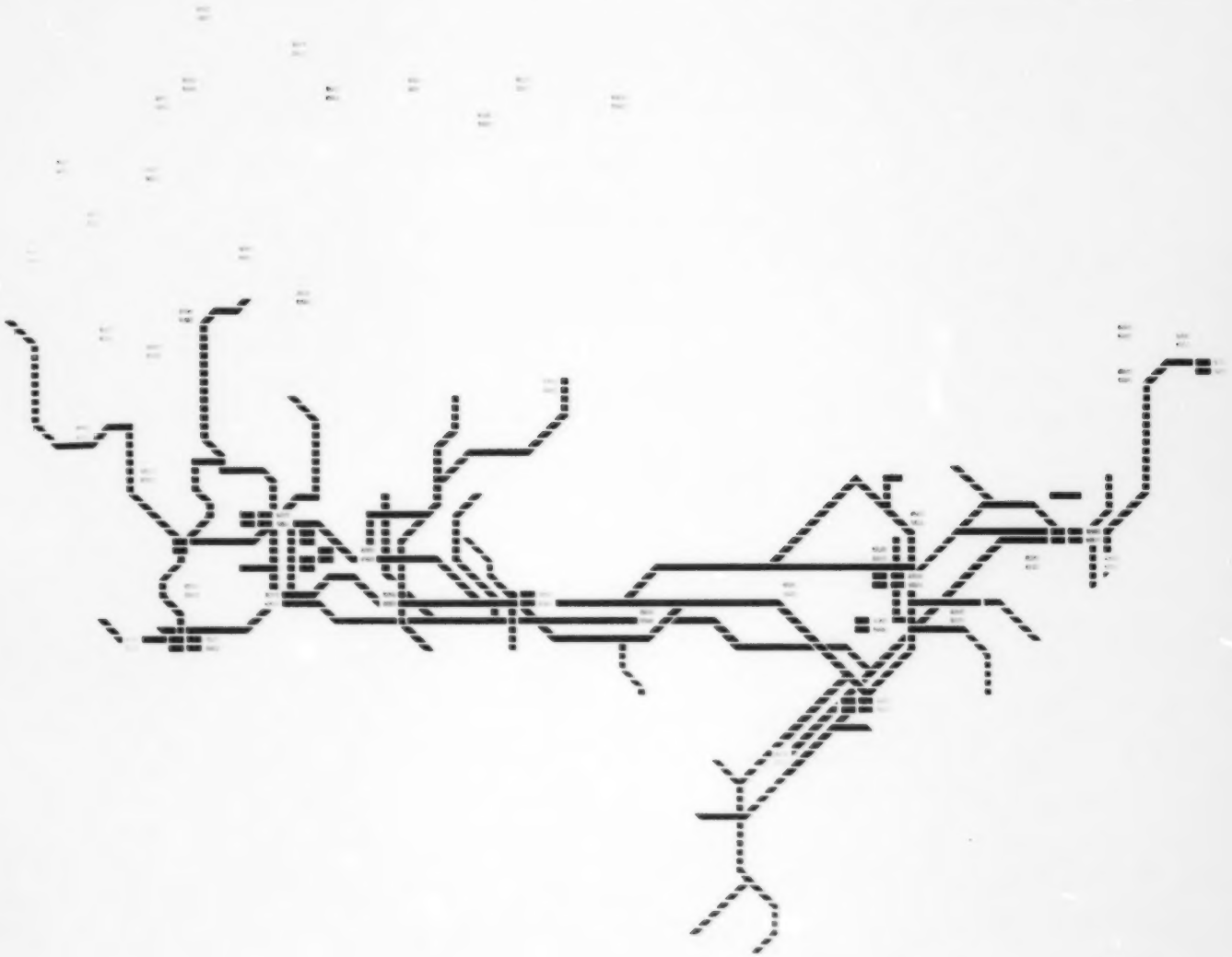
Canadian National

Annual Report 1985



The Right Connections

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The Right Connections

For 150 years CN has progressively spanned the length and breadth of the country. The CN network bridges space on the ground and through the air. As it does so, it alters our perception of that space, our relations with each other, and the possibilities for enriching those relations in the critical dimension of time.

CN's achievements in operations, engineering and efficiency are important in their own right but subordinate to the overarching goal of providing service to Canadians and to Canada. The Company's role is that of a facilitator, making it possible to cross immense distances, to communicate at lightning speeds, to move enormous loads. These tasks are routinely performed today and CN will continue to carry them out as it helps shape the space we will inhabit tomorrow.

La version française
du présent rapport
est disponible
sur demande
à l'adresse suivante:

Canadien National
Communications générales
C.P. 8100, Montréal (Québec)
H3C 3N4

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System Highlights

Five Year Financial and Statistical Summary

($ millions unless otherwise indicated)	1985	1984	1983	1982	1981
Operations					
Revenues	$5,017.8	$4,987.5	$4,659.3	$4,227.3	$4,334.5
Operating income	$ 440.0	$ 552.9	$ 465.4	$ 97.1	$ 358.9
Interest expense — net	$ 336.2	$ 349.1	$ 268.4	$ 240.4	$ 170.8
Net income (loss)	$ 117.6	$ 242.0	$ 212.3	$ (223.0)	$ 193.2
Dividend	$ 23.5	$ 48.4	$ 42.5	$ —	$ 38.6
Return on average investment %	7.2	9.2	9.1	0.3	7.8
Return on average equity %	3.5	7.5	7.1	—	6.5
Capital Expenditures					
Property and equipment	$ 744.5	$ 713.1	$ 714.4	$ 648.1	$ 662.5
Assets and Working Capital					
Current assets	$1,128.0	$1,019.9	$1,035.2	$1,006.9	$1,063.4
Working capital deficiency	$ 358.6	$ 266.7	$ 32.0	$ 9.0	$ 7.6
Properties	$6,193.5	$5,771.0	$5,612.2	$5,193.5	$4,832.1
Total assets	$8,138.8	$7,466.6	$6,789.7	$6,336.0	$6,133.8
Capital Structure					
Long-term debt (including current portion)	$3,172.2	$2,692.4	$2,357.8	$2,274.8	$1,784.2
Equity	$3,418.5	$3,324.3	$3,112.6	$2,840.9	$3,059.6
Debt ratio %	48.1	44.7	43.1	44.5	36.8
Traffic					
Revenue ton miles freight (billions)	91.6	97.4	86.7	77.8	87.9
Employees					
Average number for year	61,124	66,234	63,496	67,113	73,287
Average annual wage per employee (dollars)	$34,484	$32,905	$30,767	$28,806	$25,906
Average annual cost per employee (dollars)	$41,016	$39,339	$36,385	$34,679	$30,967
Expenditures in Canada					
Purchases	$1,232.0	$1,295.0	$1,098.0	$1,114.2	$1,195.0
Wages, salaries and fringe benefits	$2,070.0	$2,212.9	$2,002.5	$2,035.2	$1,962.1
Taxes	$ 347.0	$ 343.5	$ 300.9	$ 286.2	$ 277.4

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Directors

as at
December 31, 1985

*Appointed Chairman and Chief Executive Officer effective April 18, 1985
(1) Member of the Audit Committee
(2) Member of the Compensation Committee
(3) Member of the Investment Committee
(4) Member of the Social Responsibility Committee

G. Di Battista
end of term
April 29, 1985

E.J. Hewes
end of term
April 17, 1985

G.D. Mandel
end of term
October 2, 1985

K.R. Nurse
end of term
April 29, 1985

J.T. Sears
end of term
April 29, 1985

J.M. LeClair
O.C., M.D., LL.D.
Chairman and
Chief Executive
Officer*
Montreal, Quebec
(2)

R. Bégin
Beauport, Quebec
(1) (4)

E. Dembiw
Vegreville, Alberta
(2) (3)
effective
April 30, 1985

C.A. Fagan
St. John's,
Newfoundland
(2) (4)

J.S. Hinds, Q.C.
Sudbury, Ontario
(2) (3)

J. Johnson
Winnipeg,
Manitoba
(1)
effective
October 3, 1985

R.E. Lawless
President and
Chief Operating
Officer
Montreal, Quebec
effective
April 18, 1985

M. Marchand
North Bay, Ontario
(4)
effective
April 30, 1985

E.A. Mascoll
Toronto,
Ontario
(1) (4)
effective
April 30, 1985

D.G.A. McLean
Vancouver,
British Columbia
(2) (3)

F.D. Rosebrugh
Toronto, Ontario
(2) (3)

G.T. Urquhart
Moncton,
New Brunswick
(1)

Officers

as at
December 31, 1985

J.M. LeClair
Chairman and
Chief Executive
Officer

R.E. Lawless
President and
Chief Operating
Officer

R.C. Franklin
Executive
Vice-President

R. Boudreau, Q.C.
Vice-President —
Law

J.H. Burdakin
President
Grand Trunk
Corporation

D.H. Burstow
President
CN Real Estate

D.C. Campbell
President
CN
Communications

F.D. Campbell
Vice-President
Prairie Region

T. Cedraschi
President and
Chief Executive
Officer
CN Investment
Division

G.C. Church
Treasurer

P.A. Clarke
President and
General Manager
TerraTransport

A.E. Deegan
Vice-President
Administration

M.L. De Pellegrin
President
Canac Consultants
Limited

B.E. Ducey
Vice-President
Public Affairs
& Advertising

D.L. Fletcher
Senior
Vice-President
Operations

P.J. Foliot
Vice-President
Purchases
and Materials
Management

J.B. Griffith
President
Transport
Route Canada Inc.

J. Horrocks
Vice-President
Planning

C.J. Hudson
President
CNM Inc.

J.R. Lagacé
Vice-President
St. Lawrence
Region

G.W. Lange
Vice-President
Strategic Policy
& Planning

J.P. Laroche
Vice-President
Employee Relations

G. Maroulis
Vice-President
Internal Audit

Y.H. Masse
Senior
Vice-President and
Chief Financial
Officer

R.G. Messenger
Vice-President
Atlantic Region

W.H. Morin
Senior
Vice-President
Marketing

D.S. Oberlander
President
CN Hotels Inc.

E.D. Pinsonnault,
Q.C.
Vice-President
and Counsel

H.J.G. Pye, Q.C.
Vice-President and
Secretary

J.H.D. Sturgess
Vice-President
Great Lakes Region

S.D.H. Thomas
Corporate
Comptroller

D.E. Todd
Vice-President
Corporate
Communications

W.H. Waddell
President
CN Exploration Inc.

R.A. Walker
Senior
Vice-President
Western Canada

Companies

Companies included in the Consolidated Financial Statements of the Canadian National Railway System as at December 31, 1985

*Acquired in 1985

Consolidated Companies

Autoport Limited

Canac Consultants Limited

Canadian National Express Company

Canadian National Hotels (Moncton) Ltd.

Canadian National Railway Company

Canadian National Steamship Company, Limited

Canadian National Telegraph Company

Canadian National Transfer Company Limited

Canadian National Transportation, Limited

Canat Limited

Canaven Limited

Central Vermont Railway, Inc.

Chalut Transport (1974) Inc.

Chapman Transport Limited

CN Exploration Inc.

C.N. (France) S.A.

CN Hotels Inc.

CNM Inc.

CN Tower Limited

CN Transactions Inc.

Coastal Transport Limited

Domestic Four Leasing Corporation

Domestic Three Leasing Corporation

Domestic Two Leasing Corporation

Dorchester Express Inc.*

Duluth, Winnipeg and Pacific Railway Company

Empire Freightways Limited

Grand Trunk Corporation

Grand Trunk Land Development Corporation

Grand Trunk Radio Communications, Inc.

Grand Trunk Western Railroad Company

Mount Royal Tunnel and Terminal Company, Limited

Northwestel Inc.

Royal Transportation Limited

Terra Nova Telecommunications Inc.

The Canada and Gulf Terminal Railway Company

The Canadian National Railways Securities Trust

The Canadian Northern Quebec Railway Company

The Great North Western Telegraph Company of Canada

The Minnesota and Manitoba Railroad Company

The Minnesota and Ontario Bridge Company

The Northern Consolidated Holding Company Limited

The Quebec and Lake St. John Railway Company

Transport Route Canada Inc.

Jointly-operated and Other Companies in which the System has Investments

Canaprev Inc.

Chicago and Western Indiana Railroad Company

CN Marine Inc.

Compagnie de gestion de Matane Inc.

Computer Sciences Canada, Ltd.

Detroit River Tunnel Company*

East Yard Development Ltd.

E I D Electronic Identification Systems Ltd.

Eurocanadian Shipholdings Limited

Fort Point Holdings Ltd.

Halifax Industries (Holdings) Limited

Halterm Limited

Lakespan Marine Inc.

OCRA Communications Inc.

Seabase Limited

Shawinigan Terminal Railway Company

Société du port ferroviaire de Baie Comeau-Hauterive

Telesat Canada

The Belt Railway Company of Chicago

The Canada Southern Railway Company*

The Public Markets, Limited

The Toronto Terminals Railway Company

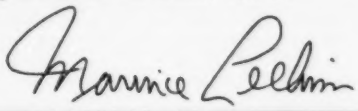
Trailer Train Company

In addition, the property of the Canadian Government Railways is entrusted to the Canadian National Railway Company as part of the System.

The Honourable Donald Mazankowski,
Minister of Transport,

Dear Mr. Minister:
In accordance with provisions of the *Railway Act*, I am pleased to submit the Canadian National annual report for the year ending December 31st, 1985.

J. Maurice LeClair
Chairman



Overview: Chairman and Chief Executive Officer

An opportunity to review the events in 1985 at Canadian National is both timely and instructive. Our company and our business environment have experienced dramatic changes over the year, changes that have occurred at an extremely rapid pace. Reflection provides a perspective from which to view these events and a framework in which to interpret them.

The first observation to be made is that CN is part of a changing national and world order. The industrial structure that has marked development in the western world for more than 150 years is in metamorphosis and its very nature is being transformed. New technology is the most highly visible instrument of this process but not the only one. Social change is equally important. We are developing entirely new skills and abilities, changing our habits and customs, our attitudes and expectations.

"The industrial structure... in the western world... is in metamorphosis..."

New patterns of international trade have found Canadian industries, particularly the resource-based and manufacturing industries that CN serves, fighting for export market share in a period of resource oversupply, emerging producer countries and, except in relation to the US dollar, a high Canadian dollar. Canadian National must be concerned with factors that affect its customers and vigilant in its efforts to improve services to them.

Our customers require more, and more complete, intermodal services as they ship relatively higher proportions of lighter, service-sensitive manufactured goods. They are looking for integrated transportation services at very competitive prices. Deregulation in the United States and the prospect of freer trade between that country and Canada offer new possibilities for growth. At the same time, they pose new challenges to existing markets and business practices.

"Our customers... are looking for integrated transportation services..."

It is exciting to be an actor on this busy stage. Over the past year, Canadian National has been intensely aware of the part it can and should play in a new business environment, aware of the needs and strengths of the other actors, and aware of the internal adjustments we must make to perform the tasks that await us.

The need for adjustment is illustrated by the financial statements that form the basis of this report. CN had a profitable year in 1985, but a much less profitable year than we anticipated at the end of 1984.

Profits in 1985 were 117.6 million dollars, down from $242 million in 1984, and far below the $258 million expected. Revenues suffered a drop of $34.1 million from a six per cent reduction in traffic, especially traffic in export grain, a $32 million decrease in revenues from VIA, and increased losses from TerraTransport and CN Route.

The developments that condition this profit performance are not temporary or cyclical. Established trends indicate that they will intensify and Canadian National must respond quickly and effectively to enhance its competitive position if it is to continue to thrive as a viable, commercial operation. As other sections of this report indicate, interest on long-term debt increased by $52.5 million in 1985. If unchecked, the growing debt ratio will shackle our ability to manage our resources.

"...downsizing does not imply any diminution of CN's commitment to socially responsible policies..."

We see that our very important human resources must be concentrated and rechannelled to produce a smaller, tighter organization. However, downsizing does not imply any diminution of CN's commitment to socially responsible policies and programs. The company will continue to foster employment equity throughout its organization with a view to increasing the proportional representation of women, native people, the disabled and members of visible minorities. We will soon introduce a refined pay-for-performance system tied to evaluation criteria that concretely define and encourage employee development.

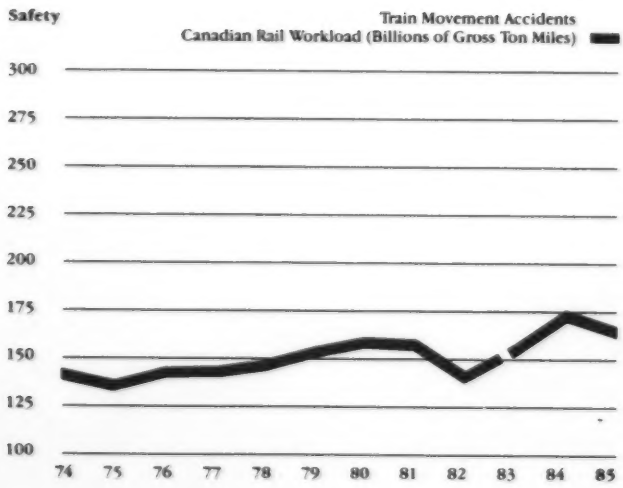
We must withdraw from businesses that are no longer viable as well as ensure that our profitable non-rail assets continue to flourish. About 70 per cent of CN's 1985 net profit was earned by our non-transportation activities and, over the next five years, we expect these assets to more than double their contribution to Canadian National's income. We are particularly confident of our prospects for increased market opportunities in information technologies and services. This area is the most dynamic growth sector in the North American economy and, while fiercely competitive, one in which we enjoy the advantages of proven reliability and expertise.

"The changes underway... represent the company's means of addressing national concerns..."

The changes underway at Canadian National are very much in the interests of our shareholder. They represent the company's means of addressing national concerns ranging from economic growth, to the deficit, to a freer trading environment. CN's continued ability to provide significant returns on the shareholder's investment is, ultimately, the measure of the effectiveness and efficiency with which we discharge our mandate.

Canadian National's status as a commercial Crown corporation places a number of unusual and competing demands upon it and these may be intensified by regulatory reform. CN is the instrument chosen to give effect to legitimate public policy objectives involving unprofitable operations ranging from services to remote communities to employment for economically depressed areas. Compensation for these activities has been absent or lagged far behind the cost of carrying them out and resulting losses have become dangerously burdensome. We must, therefore, seek relief from our shareholder in the form of either a release from obligations to continue uneconomic operations or compensation that covers actual costs.

Maurice LeClair, chairman and chief executive officer, Ron Lawless, president and chief operating officer, and Yvon Masse, senior vice-president and chief financial officer, meet in a headquarters conference room to plan Canadian National's major initiatives for the year ahead.



CN brings impressive strengths to this competitive environment. We have a strong customer base, a physical plant that is in good shape, an impressive record of technological innovation and productivity gains, a strong research-and-development component and a reputation for conscientious, forward-looking management. We have sound reasons to look to the future with optimism and confidence.

The foregoing remarks make it clear that 1985 has been a pivotal year in CN's history. Precisely because CN has a history — a long and distinguished one, I hasten to add — changes in the structure and role of our company may be viewed, initially at least, with nostalgia for the comforts of a world of certainty.

"A national transportation company that drains the public purse is not in the interests of the nation..."

In fact, such a world has never existed and Canadian National's history has been one of change, adaptation, renewal and growth. We have entered a period when these qualities will be highly visible as they create a new profile for our company. It is my conviction that this new profile is not only required but anticipated by Canadians everywhere and, in particular, by Canadians who know us and follow our activities.

Canadians expect CN to be as efficient and self-sustaining as comparable enterprises in the private sector. Not for efficiency's sake but because Canadian National has an important role to play in the creation of our national future and the way Canadian National operates says a good deal about our prospects in that future. A national transportation company that drains the public purse is not in the interests of the nation; it would run counter to strong Canadian traditions of managing the environment we inhabit even as we accept the challenges it presents.

I am glad to say that the winds of change are blowing freely within CN. We are launched on a course which demands all of our ingenuity, energies and talents in a new business order and in circumstances that will favor the survival of the fittest. We expect to be among them.

J. Maurice LeClair
Chairman and Chief Executive Officer

President and Chief Operating Officer's Message

People within Canadian National, and many people outside it, recognize that the company is in transition. We must make an important leap from today to tomorrow. There is a strong, invigorating sense of challenge about such times which shapes a kind of formula for effort. Ten per cent is made up of foresight, imagination and adrenalin. The other 90 per cent is hard work.

People at CN are good at hard work. Their efforts have been the mainstay of our successful years, among which 1985 must certainly be counted. It was successful because the potential effects on our company of the world-wide shift in markets have been contained by diligent and creative efforts to increase productivity and control costs. These efforts are responsible for our profit margin this year.

Now we must reinforce them by making the structural changes that will permit continued success. Structural change runs deep and, invariably, prompts a degree of uncertainty which persists during the period of change. I am eager to describe the changes we contemplate to groups who will be affected by them, so that they may know what to expect in this time of transition.

Changes are possible, they are desirable and they must be pursued energetically because, without massive and rapid change, the company can expect to lose over half a billion dollars during the next five years. We would require more than $3 billion in external financing and the debt ratio would move toward 70 per cent. Such a vision of our future is simply unacceptable. Fortunately, there is no doubt about the direction that change must take: we must become more competitive.

CN is no stranger to competition. We welcome it as a measure of our continued ability to run one of the biggest and one of the best railway operations in the world. The events we have witnessed in 1985 underline the need for changes in the ways we compete. Those changes will, cumulatively, make CN into a different kind of company.

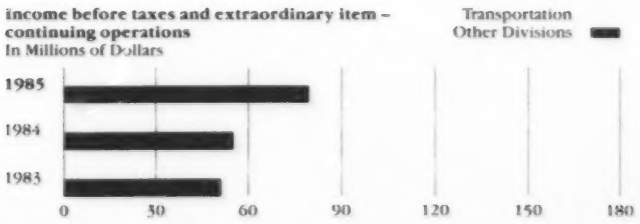
"We want our customers... to know that we are aware of... the pressures they face to become more competitive."

Certain general principles apply. Prudent financial management dictates that cost control be maintained and, where possible, expanded to lower fixed costs which, because of the sheer size of our capital plant, are extremely high. The obvious corollary is that capital spending must be curtailed to the extent consistent with continued safety and the necessary maintenance and replacement of facilities and equipment.

We want our customers, who are our life-blood, to know that we are aware of the dimensions of current market restructuring and the pressures they face to become more competitive. Like them, we are re-ordering our operations to meet more intense demands, to offer services within price structures that take account of their markets as well as ours. We expect national traffic levels to remain relatively constant for the foreseeable future. We also expect to protect and expand CN's market share of rail freight traffic in Canada.

Regulatory reform of the Canadian transportation industry will create new opportunities for transportation companies and their customers. Canadian National anticipates increased price and service competition and a greater demand for value-added and intermodal services. We are poised to respond to these conditions.

Productivity Improvement — Computer-assisted drafting machine operator Ralph Perluzzo (seated) and engineer of standards Arthur Worth tackle specifications for a new rail section. Their work ensures main line durability under heavy loads.



Early retirements, lay-offs and job redefinition have been very much a part of Canadian National's experience in 1985, and it is now well understood that this trend must continue. We must rationalize our maintenance activities, rail network, and rail terminal operations. We must pursue advantages offered by the cabooseless train program, increases in productivity and administrative streamlining. The effect of these measures will be to ensure that CN provides effective, safe, innovative and market-driven transportation and distribution services.

"We must... ensure that CN provides effective, safe, innovative and market-driven transportation and distribution services."

We must do more with fewer people. By streamlining operations and adopting existing and emerging technologies, we will be able to provide the value-added services our customers require. We must become leaner, more responsive and more flexible. Employment at CN will be reduced and, over the medium term, reflect a different mix of skills. Inevitably, cutbacks will generate distress for some individuals and resistance in some quarters. These reactions must be accepted as part of the price to be paid for essential productivity gains.

I hope that CN employees will feel confident about new directions for the company and the roles they will play in achieving our goals. Much will be required of them, especially in terms of adaptation and communication, over the next few years. Job design, job training and re-training will be refined to ensure realistic expectations for job satisfaction and career development. Fewer layers of management and more direct communications will increase mobility and broaden the scope of opportunity. Opportunities for individuals are intrinsic to a strategy of renewal; we need the best efforts our people can give us.

"...the mix of business activities in which Canadian National engages... has been the result of a series of natural marriages between our rail and other operations."

Members and officers of CN unions will recognize that new approaches to labor relations are essential. The interests of labor and management at Canadian National must become more closely identified than at any time in the past. The company will continue to seek greater employee mobility across geographic, functional, business and craft lines. Training programs will be designed to support this thrust and to permit the organization to capitalize on technological advances.

As the 1985 financial statements indicate, such advances are exploited by the mix of business activities in which Canadian National engages. Historically, this has been the result of a series of natural marriages between our rail and other operations. Together they form a strong community of businesses, a community in which the whole is more than the sum of the parts.

It will be plain to readers of this report that Canadian National has been preoccupied with change over the course of 1985. It is worth emphasizing that we are concerned with change from the inside out, with change that will redefine and transform the company. This kind of change is the opposite of cosmetic but, over a period of time, will unquestionably produce a new image of CN.

It is impossible to delineate that image, precisely because it will be a reflection of new substance and character, qualities that will emerge as change occurs. Today, our strength is in our willingness and preparedness to make the change, to reach into the future and grasp the promise it holds.

R.E. Lawless
President and Chief Operating Officer

Review of Operations

Canadian rail

Freight traffic in revenue ton miles declined in 1985 by 5.7 per cent and, consequently, revenues increased by only 0.2 per cent compared to 1984. Decreases in grain traffic of 20.9 per cent and in fuels and chemicals of 4.2 per cent account for most of this decline. The automotive segment showed a 23 per cent increase over 1984 and traffic increased in forest products, building materials, and intermodal services. These developments prompted the expansion and improvement of certain CN services and conditioned the direction of capital investment.

In recent years, Canadian National's customers have increased demands for sophisticated and innovative services that meet their total distribution requirements. In 1985, this trend clearly identified new or growing business activities for CN and now points the direction that future marketing efforts must take. Domestic intermodal traffic is the fastest-growing segment of CN's business; it has expanded on average 13 per cent per year since 1980. Intermodal business produces low profit margins as it is subject to intense competition. This characteristic calls for extremely tight cost controls.

Canadian National's past initiatives in intermodal, multimodal and distribution services positively affected market shares in several areas in 1985. Customers who make use of auto compounds, transfer yards for lumber and warehouse facilities for steel, cement and newsprint have distribution centres close to markets, access to a wider range of products and more flexible sales operations. At the same time, these facilities permit more efficient use of freight car time and space.

Engineering and design refinements in cars, locomotives, communications and schedules make contributions to CN's ability to deliver the value-added services needed in markets characterized by slow growth and increasing competition.

Noteworthy developments in 1985 are described in this section of the annual report. The account is not exhaustive but highlights efforts in 1985 and intentions for 1986, focussing on market opportunities, the application of new technologies and productivity programs. In 1985, productivity improvements and lower workloads resulted in labor force reductions of 4.1 per cent and further downsizing is an important element in overall planning.

Specialized Services

Nineteen eighty-five saw the introduction or expansion of specialized freight services tailored to market opportunities.

Launched in 1985, the Supertrain network is a series of trains operated daily across Canada and dedicated to time-sensitive freight traffic. It follows a demanding schedule discipline which ensures a high standard of reliability. In 1985, on-time performance of all trains on the Transcontinental route was 20 per cent better than in 1984, largely reflecting the contribution made by the Supertrains.

Daily Clipper service between Halifax and Toronto completed its first full year of operation in 1985. This service also specializes in speed and reliability, and it has played an important role in the strong growth performance of CN's import/export container traffic.

On the St. Jean subdivision, Marcel Lucas operates CN 9900's new electronic control system. The stretch of track on Montreal's south shore has seen constant use over the past 150 years. It began service as Canada's first railway, the Champlain and St. Lawrence.

Canadian rail Revenue by Traffic Segments

1- Fuels and Chemicals
2- Other
3- Automotive
4- Ores, Machinery and Manufactured Products
5- Intermodal
6- Grain
7- Forest Products

In 1982, CN introduced Laser, a dedicated piggyback train service between Montreal and Toronto. Laser has grown from one overnight train each way between Toronto and Montreal and, in 1985, expanded to twice each way five days a week, plus once each way between Chicago and Montreal six days a week. It uses Grand Trunk Western's main line for the US leg and takes a total of 23 hours.

CN's Cargo-Flo operation is a distribution service which mechanically transfers certain bulk commodities between train and truck. Cargo-Flo continued to expand in 1985 as new terminals and customers joined the system.

Equipment

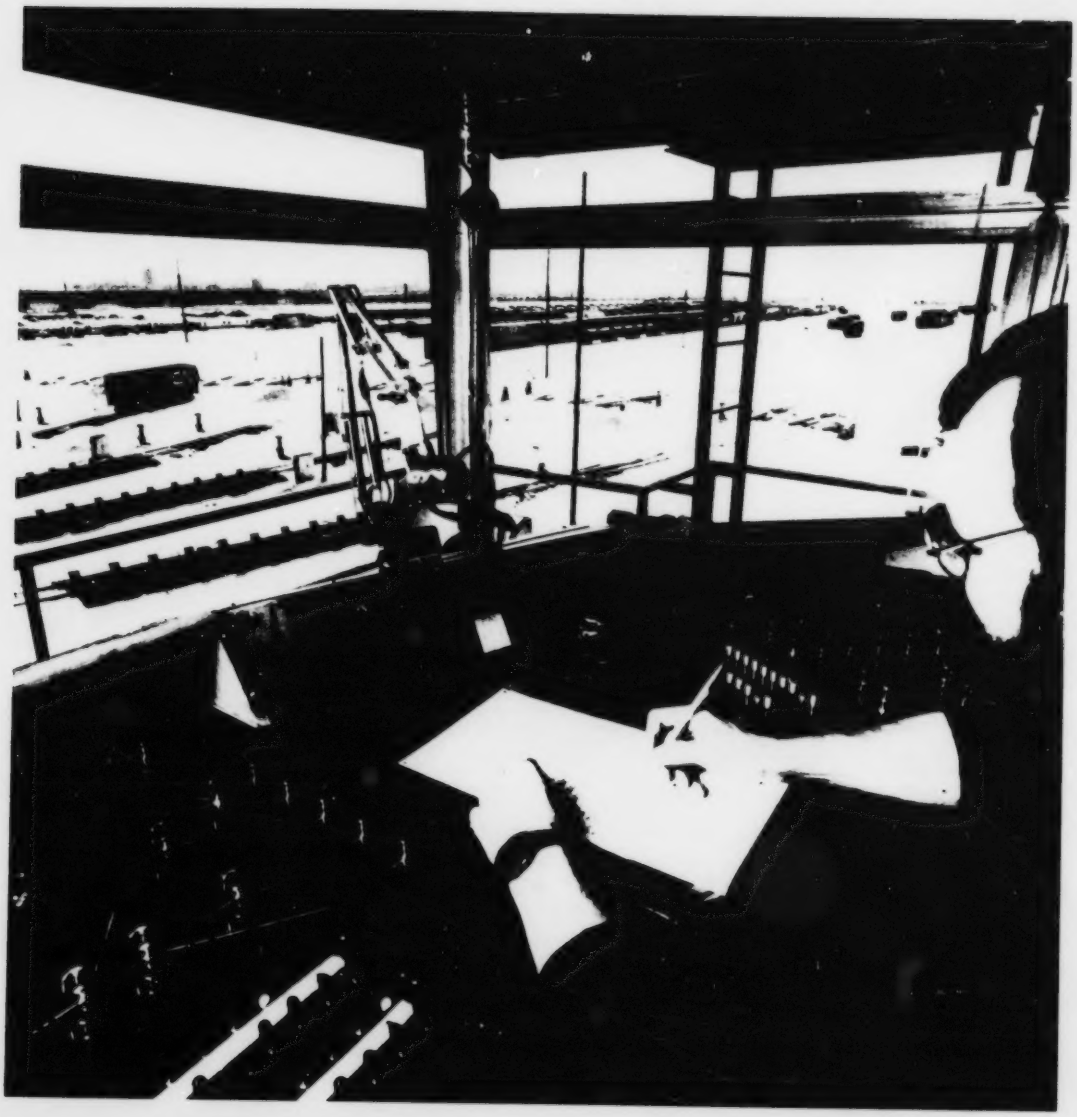
Canadian rail increased the productive use of its equipment fleet in 1985. Locomotive repair, car repair and car rental costs declined in relation to the number of miles over which the equipment was used. Based on adjusted 1984 costs, productivity in operations improved by 4.1 per cent in 1985, compared to the usual gain of about two per cent.

In May, Canadian National took delivery of the first of 44 new, high horsepower locomotives. They are 12 per cent more fuel efficient and have 10 per cent more pulling power than the preceding generation of locomotives. Four will have diagnostic microcomputers on board to analyse and predict maintenance requirements.

The company acquired new freight equipment for expanded and improved piggyback and container service. During the year, CN introduced a new low-deck trailer flat car, which carries trailers up to 4.1 m high. These cars are used for Laser service between Montreal or Toronto and Chicago through the St. Clair Tunnel at Sarnia, as well as for the Toronto-Moncton Clipper trains; 78 of them are now in service.

Four new cars with similar features are being used in double-stacked container tests on the Clipper service between Toronto and Halifax. CN purchased 219 trailers for piggyback service. Each trailer is 14.6 m (48 feet) long and has a carrying capacity of 98.5 m^3, an 11 per cent improvement over existing piggyback units.

Canadian National completed design work for, and built a prototype of, a new grain car in 1985 at the request of the Government of Canada and the Province of Manitoba. This development was prompted by gradual retirement of the existing boxcar fleet. The rail line to Churchill, part of which is laid over permafrost, cannot safely handle the present generation of grain hoppers.



Inside the control tower at Montreal's Taschereau Yard, William Stasiaky routes a time-sensitive shipment to destination. CN is testing new systems to upgrade operations at major freight yards.

Average number of Employees
In thousands

Infrastructure and Technology

The Company continued to renew and improve its basic fixed plant by channelling investment toward the main lines, key terminals and major equipment servicing and repair facilities. Over the year, 822 km of replacement rail were laid and significant tie and ballast renewal programs were completed.

Canadian National's capacity expansion in western Canada has been underway since 1980. In 1985, 38 km of double-track were placed in service between Edmonton and Vancouver, bringing the double-track total to 390 km on the 1200 km route. Major modifications to the Kamloops, Prince George and Smithers yards and extensive work in the Vancouver terminal were carried out. The rail line between Prince George and Prince Rupert was converted to a fully centralized traffic control system operated from Prince George and using rail traffic control technology developed by Canadian National.

Fibre optics technology uses laser beams to transmit voice and data messages through hair-thin glass fibres. In April, Canadian National and CNCP Telecommunications undertook a three-year joint project to make use of this technology.

In the east, the fibre optics network links Toronto, Montreal and Ottawa along the 750 km CN right-of-way. As more advanced train control systems are introduced, fibre optics installations will provide the increased transmission capacity required.

Fibre optic installation is scheduled for the 1,200 km Edmonton-to-Vancouver route. Cable installation, using a rail-mounted cable plough developed by Canadian National, began in 1985.

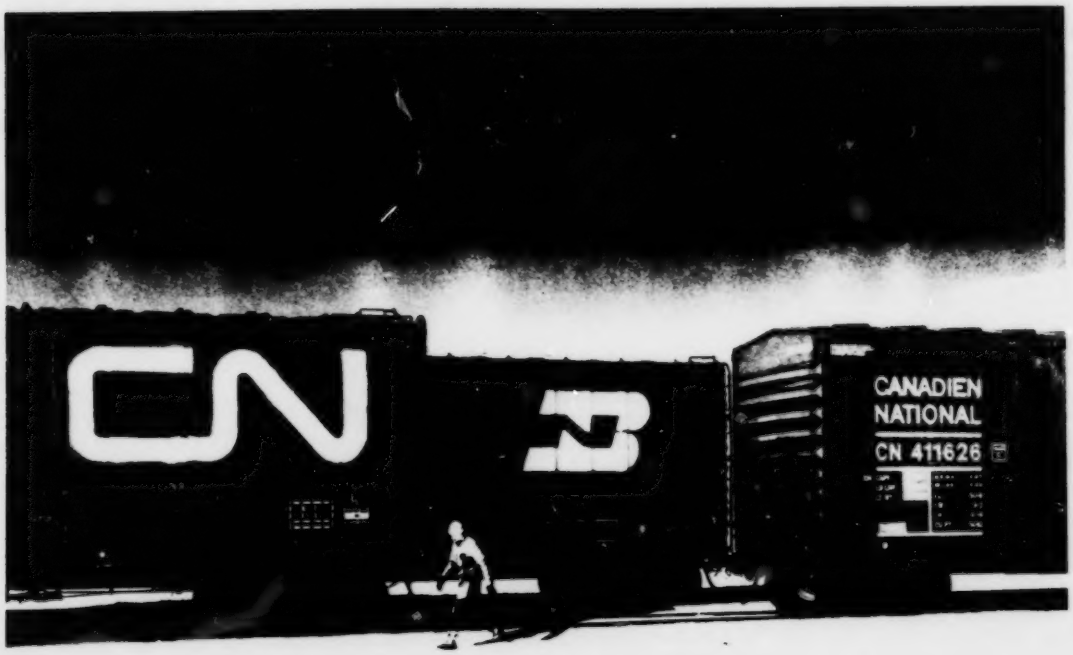
CN has taken an active role in the advanced train control systems project which is a joint undertaking of Canadian and US railways. Its purpose is to develop comprehensive systems to control train movement by replacing existing railway signalling with computer and communications technology.

Advanced operating systems will improve safety, productivity and energy efficiency. Modular system design will allow user railways to configure individual systems to their particular operating needs and to change systems as required. Implementation will take place over the next decade.

During 1985, six computer-assisted yard-crew dispatching desks began operations, a major step toward fully automated crew dispatching, record keeping and an automated running trades payroll system. As a result, all but two of 65 local crew-calling offices were consolidated into five regional crew-management centres by the end of 1985.

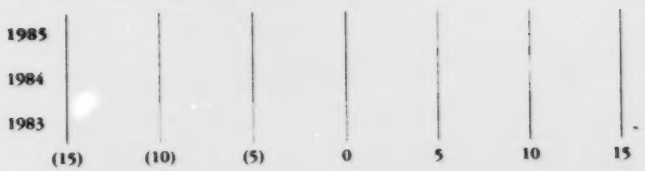
End-of-train information systems are composed of electronic modules which provide the front-end crew of a train with information and controls that make possible the safe elimination of cabooses.

Extensive testing of end-of-train information systems has been carried out since November of 1985 under the authority of the Canadian Transport Commission. With regulatory approval and adoption of these systems, CN anticipates annual savings in equipment of about $30 million.



Open Spaces and a Vast Potential — An agreement in 1985 between Grand Trunk Corporation and Burlington Northern facilitates operations and increases the volume of traffic flow between the CN network and the American heartland. Yardmen like Martial Laberge keep the traffic moving through key gateways.

Grand Trunk Corporation Income (loss)
In Millions of Canadian Dollars



Passenger Operations

In 1985, CN continued to cooperate with government to alter VIA train operations and improve equipment, maintenance and station services.

In July, CN transferred to VIA approximately 1,200 employees and certain Montreal and Toronto facilities for maintenance and servicing of rolling stock. Further changes of this kind are planned for 1986 and negotiations are underway to transfer train and engine crews assigned to passenger services. The operation and maintenance of 290 railway passenger stations was conveyed to VIA through a long-term lease in December.

TerraTransport

TerraTransport manages CN's freight and intercity bus services in Newfoundland. A five-year government-funded program to revitalize rail operations was completed in March 1985. The program streamlined operations and improved market share to control TerraTransport's deficit which now holds at about $40 million.

Government decisions on the future of TerraTransport had not been reached at year end. CN has indicated that the company would be willing to continue to manage Newfoundland services under an agreement which would provide adequate compensation.

Grand Trunk Corporation

Grand Trunk Corporation (GTC) earnings continued to improve in 1985. GTC, comprising Grand Trunk Western Railroad Company (GTW), Duluth, Winnipeg and Pacific Railway Company and the Central Vermont Railway Inc., anticipates a profitable 1986.

As a part of the North American rail network, GTC maintains strong links with many connecting railways. A voluntary coordination agreement with Burlington Northern became effective in January, 1985. It facilitates coordinated marketing and operations on certain major routes of Burlington Northern, GTC and Canadian rail.

Both Grand Trunk Western and Central Vermont won *Modern Railroads*' Golden Freight Car awards for excellence in railway freight service marketing in 1985.

During the year, more than 422 km of fibre optic cable was installed on various segments of the Grand Trunk Western right-of-way by five communications companies. The new services generated $3.4 million in revenue and GTW has access to much of this system for its own long distance calls and data transmission.

GTC opposes the US Department of Transportation's proposal to dispose of its interest in Conrail to Norfolk Southern because it believes the proposal to be anti-competitive and potentially harmful to Grand Trunk Western and Central Vermont. GTC supports the continued existence of Conrail as an independent, publicly held company.

To facilitate and preserve GTW's participation in the North American automotive market, 570 multi-level cars were leased in 1985.

Employee Relations

National labor negotiations between CN and its unions began late in 1984 and were completed early in 1986. Signed contracts terminate December 31st, 1986 and provide for four per cent wage increases each year effective January 1st. For non-operating employees, a no lay-off clause provides employment security for those with eight or more years' service who are affected by technological, operational or organizational change.

More flexible relationships between unions and the company are reflected in new contract provisions. United Transportation Union (UTU) employees hired after February 1st, 1986 will be paid 75 per cent of regular rates for one year. Eating and rest provisions were modified and modernized in contracts with both the UTU and the Brotherhood of Locomotive Engineers and separate benefit plans were negotiated with each union group rather than on an industry-wide basis.

Pay-for-performance guidelines resulted in changes to the company's management compensation program in 1985. Procedures used to assess employee performance were refined to reflect these guidelines and to recognize and encourage individual initiative. A custom-designed special early retirement and separation plan was implemented to complement the downsizing measures contemplated for 1986.

The company's employment equity policies were translated into an active program in 1985. Designed to increase the representation of women in all functions and coordinated by a network of 37 officers, the program has shown measurable results.

CN sponsored a scholarship program for women beginning technical and trades training at Canadian colleges, improved maternity benefits and developed a day-care pilot project.

In 1986, the employment equity program will implement action plans to build on these achievements. Work will go forward to meet employment equity objectives in relation to three additional groups: aboriginal peoples, the disabled and members of visible minorities.

CN's youth employment program, launched in 1984, has provided opportunities for the development of portable and marketable job skills to 243 Canadians between the ages of 16 and 25. The program places young people on learning assignments for a period of up to three years.

CN Route

Since 1983, CN Route has offered trucking and distribution services and operated 53 terminals across Canada. Despite a number of plant modernization and rationalization techniques, and aggressive marketing programs, CN Route and its predecessor operations have been unprofitable for five years and the 1985 loss of $42.6 million reflects a revenue reduction of $18.7 million compared to 1984. For these reasons, and because excess capacity and intense competition are expected to remain dominating characteristics of the industry, CN has resolved to merge, sell or close CN Route.

In 1985, the division lowered payroll and fringe benefit costs by $12.8 million and non-payroll costs by $4.6 million. Marketing efforts included the introduction of a common tariff, a national accounts program and a sales award program. Customer service levels were improved.

Marketing initiatives have been complemented by productivity improvements. In 1985, four garage facilities were absorbed and the truck, tractor and trailer fleets were reduced by 26, 18 and 10 per cent respectively. Staff decreased by 450 in 1985 to an average number of 2,522.

Despite these efforts and considerable other achievements, traffic declined and CN Route found itself increasingly unable to reduce losses.

CN Communications

Each of the units making up CN Communications improved performance in 1985. Overall, a record profit of $43 million was achieved, 32.9 per cent more than in 1984, and CN Communications moved closer to realizing annual growth rates comparable to those of the industry generally.

CNCP Telecommunications contributed $16.3 million, an 18.1 per cent improvement over 1984. A small rate increase in January coupled with business growth throughout the year produced increased revenues. However, these were lower than expected due to competitive pressure.

In August, the Canadian Radio-television and Telecommunications Commission denied CNCP's application to provide competing long distance telephone service to the public. In December, CNCP appealed to the commission to review and vary its decision. Public comment on the application has been requested, and it is anticipated that a hearing will be held on this matter.

CNCP and AT&T Communications in the US negotiated an interconnect agreement on trans-border services. The agreement will permit marketing of a wider range of services in both countries.

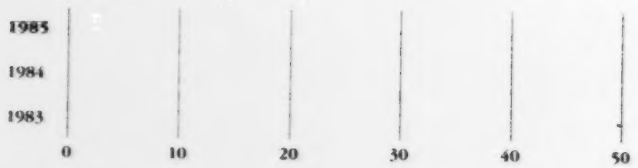
Terra Nova Tel provides telephone service in Newfoundland and Labrador. In 1985, Terra Nova earned $6.8 million, 11.6 per cent more than in 1984. The number of subscribers grew by three per cent and long distance revenues by six per cent. An August rate increase, productivity improvements and continuing plant modernization contributed to Terra Nova Tel's 1985 profit performance.

NorthwesTel supplies telephone services in northern British Columbia, the Yukon and western Northwest Territories. The company's income rose to $12.5 million, a gain of 3.9 per cent over 1984. Better business conditions in the Northwest Territories and a rate increase effective in November are factors affecting this increase.

Several remote communities served by NorthwesTel were linked by a system of satellite communications. A continuing exchange modernization program replaced 10 electromechanical exchanges with new digital equipment and solid state digital exchanges were placed in service at Yellowknife and Whitehorse.

From Toronto to...
— Supplementing land lines and a microwave network, CNCP Telecommunications bridges Canada's vast regions efficiently with satellite links, strengthening CNCP's position as a major competitor for business communications across Canada.

CN Communications Income
In Millions of Dollars



Telecommunications Terminal Systems is a company established in partnership with Canadian Pacific Limited in 1982 to sell, install and maintain private telephone switchboards and terminal equipment for connection to the public telephone network. In 1985, it achieved a revenue gain of 12.9 per cent in a difficult market.

CN Hotels

CN Hotels operates seven hotels across Canada. In 1985, the company lost $3.4 million, an improvement of $1.9 million over 1984, and began a program which will systematically upgrade and refine services for a demanding and diversified clientele.

All CN hotels introduced Entrée Silver, a standard of service designed to meet the needs of senior executives. Entrée Gold, a premium version of this type of service, was added at the Queen Elizabeth in Montreal and at the Hotel Vancouver. The bonus program for frequent guests at CN Hotels was enhanced and subsequently associated with Air Canada's Aeroplan.

The first phase of renovations to the Château Laurier was completed and unprofitable restaurant operations in Montreal's Place Ville Marie were closed.

CN Exploration

CN Exploration has drilled and developed oil and gas wells in Saskatchewan since 1981 and 1985 was its busiest and most profitable year. Profits grew to $30.6 million, up from $15.9 million in 1984. The current depressed oil price will, however, have a significant impact on 1986 net income.

CN Exploration was the third most active driller in Saskatchewan in 1985 and, at the end of the year, had an interest in 469 oil wells. Oil production peaked at 5,300 barrels per day.

On the basis of a 1985 discovery on the company's freehold lands near Donegal, more drilling in this area is planned for 1986. The company assesses this reservoir as particularly suitable for a thermal recovery process.

CN Real Estate

CN Real Estate develops and manages properties owned by Canadian National. In 1985, the division enjoyed its fifth consecutive profit-making year. Profits were $14.7 million.

The City of Toronto approved plans for the redevelopment of railway lands in its downtown area and the Province of Ontario selected a site near the CN Tower for a new domed stadium, for which CN is supplying much of the required land. In addition, the redevelopment will create 5,000 residential units, 558,000 m^2 of commercial, industrial and retail space and six hectares of parkland.

The Toronto Convention Centre Complex completed its first full year of operation in 1985. The complex is now fully leased and financial yields have exceeded forecasts. Renovations to the office building at 151 Front Street in Toronto began. They include a new entrance, a renovated lobby and a retail arcade which will open in the spring of 1986.

1985 brought a major contract between CN's consulting firm CANAC and Indian Railways. CANAC will provide computer software and technical services for advanced systems to locate and control freight cars.

Construction started on a 10-storey office building at Howe and Smithe Streets in Vancouver. Directly across from Robson Square and the Law Courts, the building will house an international insurance brokerage firm and the Public Legal Education Society. It will be occupied in the spring of 1987.

In the Montreal region, a further 200 residential units were completed by local developers in Pointe-aux-Trembles to bring the number of units completed or under construction to 1,000. On the Bonaventure lands, 140 units were finished by the end of the year.

In December, agreement was reached with the City of Waterloo to construct a commercial building providing 7,626 m^2 of space on a downtown site. The City's municipal offices and council chambers will occupy approximately half of this space. Construction will begin in the spring of 1986.

CANAC Consultants Limited

CANAC offers consulting, construction and other services world wide. Based on railway and technical expertise, CANAC operations have expanded into the fields of communications, computerization, management and technical training.

In 1985, the company signed a $25 million, seven-year contract for computer software and technical services with Indian Railways. The software is derived from the freight car location and control system developed by CN. A rail car control contract was also signed in China. Initial testing using CN computer software will be carried out in 1986.

CANAC aggressively marketed telecommunications services in 1985, particularly in Canada and many in association with CN Communications. With Microtel in British Columbia, CANAC successfully bid on part of the $230 million satellite-based defence communications network of the North Warning System which will eventually replace the Distant Early Warning System in the Canadian arctic.

In Mexico, CANAC prepared and presented a management training course in Spanish. The course was for senior training officers of Mexican National Railways. CANAC will seek opportunities to provide training to other companies and in other countries.

In 1985, CANAC continued to provide technical assistance and consulting services to VIA Rail on a wide range of projects. A newly formed sales and service group within CANAC concluded a long-term contract with the Port of Montreal to manage the servicing and maintenance of port locomotives, and had other contracts in hand worth about $2 million.

In keeping with Canadian government guidelines concerning commercial practices of Crown corporations in international trade, and to enhance CANAC's competitiveness abroad, CN's board of directors has approved the opening of a corporate register containing the names of CANAC business representatives, and their aggregate remuneration, to be maintained by the secretary of the corporation.

Results of Operations

System net income for the year 1985 amounted to $117.6 million, a decrease of $124.3 million from the record level of 1984. Most of this decrease occurred in the Canadian railway operating divisions — Canadian Rail and TerraTransport — where income fell by $118.6 million due mainly to traffic volume declines. Decreasing traffic was also a factor in CN Route's increased loss in 1985. CN Marine Inc., which earned income of $21.9 million in 1984, was not a part of the System during 1985. Income from Grand Trunk Corporation and other divisions increased by $26.9 million or 39.5%.

The main factors accounting for the $29.6 million improvement in net income in 1984 when compared with 1983, were increased traffic volumes in the railway operating divisions, and income improvements in other divisions together with a decreased loss in CN Route. Tempering the System improvement were increased interest costs. Most of this increase arose as a result of revised accounting requirements relating to the deterioration in the Canadian dollar in the past few years. This change added $65.4 million to reported expenses. For purposes of comparison this amount has been assigned to the divisions in the accompanying System Consolidated Financial Statements.

In accordance with applicable legislation, the Company provided for a dividend of 20% of net income to the Government of Canada. The dividend amounted to $23.5 million in 1985, $48.4 million in 1984 and $42.5 million in 1983.

The results for each division, which are discussed below, include the assignment of interest expense. This expense aggregated $336.2 million for the System in 1985, $349.1 million in 1984 and $268.4 million in 1983. The 1985 decrease is accounted for by the designation of future U.S. dollar revenue streams as a hedge against unrealized losses on translation of U.S. dollar denominated long-term debt. This permitted the Company, in 1985, to eliminate the amortization of such losses and thereby reduce income only by the amount of losses realized by payment of such debt. Thus, despite an increase of $52.5 million in total interest on long-term debt, the overall interest costs are down compared to 1984. See Note 9 of Notes to Consolidated Financial Statements.

Canadian Rail

Canadian Rail's net income for 1985 totalled $105.5 million, as compared with $218.9 million in 1984 and $221.8 million in 1983. The principal factors accounting for the declines were 1985 traffic volume decreases, particularly in grain, and, in the case of the 1984-83 comparison, higher interest expense in 1984.

Railway operating revenues amounted to $3,753.2 million in 1985, down $34.1 million from 1984 and up $366.5 million from 1983. The most significant factor in this reduction was the downturn in freight traffic volume which reduced revenues by approximately $90 million. The reduction in revenue from grain traffic alone was greater than the overall decrease but there was also a major decrease in revenues from the VIA Rail contract, because of the assumption of repair responsibilities by VIA Rail in July 1985. The use of U.S. dollar revenues to hedge debt repayments in that currency reduced revenues further. These decreases were partially offset by higher revenues in Forest Products, Automotive, Construction — Basic Building Materials and Intermodal, which reflected higher volumes of business, rate increases and traffic mix improvements. In addition, revenue gains were made in Commuter and Other Services revenues.

In 1984 freight services revenues were the major factor in the revenue improvement. Higher traffic volumes were obtained in most commodity groups reflecting the improved economic climate in Canada and the U.S. Also of importance were revenues received under the Western Grain Transportation Act. Although the adoption of the WGTA resulted in a significant reduction in Government payments for branch lines and the termination of the interim grain payment arrangement, the net result was an increase over the amounts earned under previous arrangements.

Expenses in 1985 were $3,647.7 million, up $79.3 million from 1984 and $482.7 million from 1983. The main factors in the 1985 increase were inflation-related increases in payroll and material costs and the cost of a special non-continuing employee early retirement and separation plan, offset to some extent by a reduction in workload volumes and interest expense. The 1984 increase was mainly attributable to traffic volume increases, wage and material price inflation, and higher pension, tax, depreciation and interest costs, partially offset by improvements in operating efficiency.

TerraTransport

TerraTransport's loss in 1985 was $39.9 million compared with losses of $34.6 million in both 1984 and 1983. The 1985 deterioration was attributable to reduced revenues due mainly to the receipt in 1984 of higher branch line subsidies for earlier years and lower freight traffic. Expense decreases due to efficiencies related to containerization and the drop in traffic levels were not sufficient to overcome the revenue decline. In 1984, increased revenues were offset by inflation-related expense increases and higher interest costs.

Grand Trunk Corporation

Grand Trunk Corporation's income amounted to $13.6 million in 1985 compared with $11.7 million in 1984 and a loss of $12.9 million in 1983. The 1985 improvement resulted from increased other income including a refund of property taxes, lease income and gains on U.S. exchange, which together with reduced interest expense, more than offset the effect of inflationary cost increases and the adverse effect on revenues of decreased revenue ton miles. A strengthened U.S. economy along with measures taken to penetrate new markets and to reduce costs accounted for the 1984 turnaround.

Revenues amounted to $551.8 million in 1985, $524.0 million in 1984 and $436.5 million in 1983. The 1985 revenue increase was due mainly to the rise in relative value of the U.S. dollar. Carloadings increased but average haul decreased, resulting in a drop in revenue ton miles. Higher traffic volumes were achieved in the automotive, fuel, pulp and paper and metals groups, while the traffic in the grain, food products, lumber, fertilizer and intermodal groups declined. The 1984 revenue increase reflected higher traffic volumes, particularly in the automotive, coal, coke, intermodal and fertilizer groups.

Expenses totalled $538.2 million in 1985, $512.3 million in 1984 and $449.3 million in 1983. The rise in the relative value of the U.S. dollar, inflationary pressures, increases in fringe benefit taxes and higher casualty insurance costs, offset to some extent by a property tax refund, lease income and lower interest expense accounted for the 1985 rise. The 1984 expense increase was due mainly to higher traffic volumes and moderate inflationary pressures.

CN Route

CN Route, the Company's trucking division, had a loss of $42.6 million in 1985, compared with losses of $31.9 million in 1984 and $33.7 million in 1983. The increased loss in 1985 was mainly because of a drop in traffic volumes and revenues, increases in interest costs and reduced other income. Tariff increases and expense savings from volume reductions were not sufficient to offset the revenue decreases. The 1984 improvement was due mainly to the savings arising from combining the management of the former CN Trucking and CN Express Divisions.

Other Divisions

CN Communications

CN Communications' income in 1985 was $43.0 million, compared with $32.4 million in 1984 and $34.2 million in 1983. The $10.7 million increase in 1985 was mainly due to higher revenues resulting from rate increases and volume growth and to reduced interest costs. The $1.8 million decrease in 1984 reflected mainly higher interest costs.

CN Hotels

CN Hotels had losses amounting to $3.4 million in 1985, $5.3 million in 1984 and $2.9 million in 1983. In 1985, higher occupancy rates and higher average revenue per room along with improved results from the CN Tower and other operations were partially offset by restaurant closing costs and higher interest expense. Income in 1985 also benefitted from a business tax recovery of $0.9 million. Increases in interest costs, together with certain 1983 non-recurring items of income, were the most significant factors in the 1984 loss increase.

CN Exploration

CN Exploration earned income of $30.6 million in 1985, a growth of $14.7 million over 1984 and $20.3 million over 1983. Increased oil production accounted for most of the improvements in both years.

CN Real Estate

Income from CN Real Estate amounted to $14.7 million in 1985, up $0.6 million from 1984 and $4.2 million from 1983. The 1985 betterment reflects increased income from property operations and reduced interest expense which more than offset a reduction in profits from land sales. In 1984, increased profits from land sales accounted for nearly all of the improvement.

Dockyard and Other

Dockyard and Other operations had losses of $3.4 million in 1985, $0.6 million in 1984 and $0.3 million in 1983. The major part of the 1985 loss was incurred in dockyard operations. The increase in the loss over 1984 was attributable almost equally to a loss position in Canac Consultants' results and higher dockyard losses. In 1984 reductions in dockyard business accounted for most of the downturn.

Income Taxes

Total income taxes for 1985 have been reduced by the amount of $57.4 million through utilization of tax benefits pertaining to prior years' losses, which reduction was accounted for as an extraordinary item. The corresponding amount for 1984 was $116.7 million and for 1983, $99.4 million. See Note 10 of Notes to Consolidated Financial Statements which indicates that such benefits are available to reduce taxable income of future years.

Liquidity and Capital Resources

As reflected by the Consolidated Statement of Changes in Financial Position, there was a decrease in cash of $61.0 million in 1985 much of which can be attributed to the fact that internally-generated funds were insufficient to cover capital investments. The same factors accounted for the 1984 cash decrease. In 1983, most of the increase in cash was due to improved cash flow from operations. Cash deficiencies are financed by short-term bank borrowings. At December 31, 1985, short-term bank loans amounted to Canadian $59.1 million. The Company has arrangements with a number of Canadian and U.S. banks which provide lines of credit in excess of the Company's anticipated short-term borrowing requirements.

In 1985 the Company issued new debt of $597.1 million of which $131 million was in the form of capital leases and equipment purchase agreements. $236.5 million of long-term debt was retired during the year.

As a consequence of the new borrowings during the year and the continuing decline in the value of the Canadian dollar in relation to the U.S. dollar, the Company's year-end debt ratio increased to 48.1% from 44.7%.

Under Orders in Council issued in December 1984, control of CN Marine Inc., a wholly-owned subsidiary of the Company, passed to the Government of Canada on January 1, 1985. On December 5, 1985, the Marine Atlantic Inc. Acquisition Authorization Act was given first reading in the Parliament of Canada. The Act, if enacted, would change the name of CN Marine Inc. to Marine Atlantic Inc. and would authorize and require the Company to transfer to the Government of Canada all the common shares of this subsidiary held by the Company and certain property and works related to this subsidiary. In consideration of such transfer, the Government would be authorized to transfer to the Company, for cancellation, 655,116 common shares of the Company. The book value of the System's investment in CN Marine Inc. and such related property and works is $327.5 million, which corresponds with the book value of the said shares of the Company to be transferred and cancelled. The cancellation of the shares will increase the Company's debt ratio.

In March 1986, the Company issued $100 million 9-7/8% Notes due March 18, 1994 in the Euro-Canadian dollar market and borrowed $70 million at an all-in cost of 10.25%, by means of a Euro-yen public note issue due March 26, 1996 and currency swap.

Planned capital expenditures for 1986 are approximately $540 million. In addition, the Company anticipates that capital expenditures for 1987 and 1988 will aggregate approximately $1.1 billion. The capital expenditure program for 1986 to 1990 includes funds required for the expansion of roadway property in Western Canada, renewal of basic plant, purchase of rolling stock and other equipment and improvement of operating efficiency. The Company expects that although the major portion of these expenditures will be funded internally, the balance, together with provision for existing debt maturities, will require further borrowings.

At December 31, 1985, the Company had commitments to purchase railway ties at an aggregate cost of $38.5 million and rolling stock of $38.6 million.

Inflation

The Company's 1985 inflation rate for wage, fuel and material costs was around 5% compared with an estimated 4% increase in the Canadian Consumer Price Index. The corresponding figures for 1984 were about 4% and 4.4% respectively and for 1983, about 5.8% for both rates.

The 1985 increase in the Company's rate of inflation is due to higher fuel prices brought about by an increase in the excise taxes on diesel fuel. Excluding fuel, the Company's inflation rate was approximately 3.5%.

In 1983 and 1984, the effect of the Government of Canada's policy guidelines to combat inflation was felt. In addition, fuel prices stabilized and interest rates fell from their record-high levels.

The Government's original guidelines called for a limiting of price increases for goods and services sold by Crown Corporations and federally-regulated industries to 4% for the period from June 1984 to June 1985. However, effective November 8, 1984, the guidelines were removed and no compulsory Government wage or price guidelines are now in force.

In recognition of the need to supplement the historical cost information provided in the financial statements, the Canadian Institute of Chartered Accountants, in December 1982, issued recommendations for the reporting of certain effects of changing prices on an enterprise. These recommendations became effective in 1983 and the information for the Company is shown following the Notes to Consolidated Financial Statements. While not as significant as in some previous years, the inflation rates in the 1983 to 1985 period continue to exert upward pressures and the cumulative effect of many years of rising prices on the Company is pronounced.

Consolidated Statement of Income

Year ended December 31	1985	1984	1983
(in thousands)			
Canadian Rail			
Revenues	$3,753,190	$3,787,251	$3,386,723
Expenses	3,647,658	3,568,384	3,164,910
Income	105,532	218,867	221,813
TerraTransport			
Revenues	25,919	33,365	28,095
Expenses	65,827	67,986	62,737
Loss	(39,908)	(34,621)	(34,642)
Grand Trunk Corporation			
Revenues	551,782	524,035	436,464
Expenses	538,200	512,347	449,335
Income (loss)	13,582	11,688	(12,871)
CN Route			
Revenues	144,681	163,427	169,656
Expenses	187,271	195,365	203,316
Loss	(42,590)	(31,938)	(33,660)
Other Divisions:			
CN Communications			
Revenues	303,930	287,786	263,665
Expenses	260,882	255,398	229,503
Income	43,048	32,388	34,162
CN Hotels			
Revenues	129,846	102,186	103,340
Expenses	133,289	107,489	106,252
Loss	(3,443)	(5,303)	(2,912)
CN Exploration			
Revenues	56,730	31,873	24,667
Expenses	26,123	15,973	14,369
Income	30,607	15,900	10,298
CN Real Estate			
Revenues	29,582	30,544	22,701
Expenses	14,885	16,481	12,182
Income	14,697	14,063	10,519
Dockyard and Other			
Loss	(3,422)	(588)	(270)
Total Other Divisions			
Income	81,487	56,460	51,797
Total Continuing Operations	118,103	220,456	192,437
CN Marine Inc.			
Income	—	21,888	19,803
Income before income taxes and extraordinary item	118,103	242,344	212,240
Income taxes	57,823	117,123	99,290
Income before extraordinary item	60,280	125,221	112,950
Reduction in income taxes on application of prior years' losses	57,359	116,730	99,383
Net income	$ 117,639	$ 241,951	$ 212,333

See accompanying notes to consolidated financial statements.

Consolidated Balance Sheet

December 31		1985		1984
(in thousands)				
Assets				
Current Assets				
Accounts receivable		$ 486,922		$ 427,622
Material and supplies		406,184		390,362
Other current assets		234,849		201,901
		1,127,955		1,019,885
Insurance Fund		9,176		5,612
Investments		380,011		362,121
Properties		6,193,468		5,770,982
Other Assets and Deferred Charges		428,171		308,011
		$8,138,781		$7,466,611
Liabilities				
Current Liabilities				
Bank loans and other indebtedness		$ 152,719		$ 91,687
Accounts payable		664,516		645,725
Accrued charges		289,719		261,545
Current portion of long-term debt		223,885		119,773
Other current liabilities		155,732		167,900
		1,486,571		1,286,630
Provision for Insurance		9,176		5,612
Other Liabilities and Deferred Credits		271,891		273,071
Long-Term Debt		2,948,347		2,572,613
Minority Interest in Subsidiary Companies		4,345		4,345
Shareholder's Equity				
Capital stock of Canadian National Railway Company; 6,523,902 (1984 – 6,523,902) common shares of no par value authorized, issued and outstanding	$2,606,425		$2,606,425	
Retained earnings	812,026	3,418,451	717,915	3,324,340
		$8,138,781		$7,466,611

See accompanying notes to consolidated financial statements.

On behalf of the board:
J. Maurice LeClair, Director
Ronald E. Lawless, Director

Consolidated Statement of Retained Earnings

Year ended December 31	1985	1984	1983
(in thousands)			
Balance, beginning of year	$ 717,915	$ 524,354	$ 354,487
Net income for the year	117,639	241,951	212,333
	835,554	766,305	566,820
Dividend	23,528	48,390	42,466
Balance, end of year	$ 812,026	$ 717,915	$ 524,354

See accompanying notes to consolidated financial statements.

Consolidated Statement of Changes in Financial Position

Year ended December 31	1985	1984	1983
(in thousands)			
Cash (Indebtedness), beginning of year	$ (91,687)	$ 58,944	$ (114,005)
Provided from (used for) operations			
Sources:			
Net income for the year	117,639	241,951	212,333
Non-cash charges to income:			
Depreciation	282,319	260,950	254,006
Other amortization	498	494	508
Loss (income) of equity investees less dividends	308	(16,207)	731
Loss on disposal of investment	737	—	—
Changes in working capital items*	(73,273)	11,017	183,282
Net proceeds from disposal of assets	39,670	31,874	41,728
Proceeds from sale of investment	1,571	—	—
Other	(12,884)	(26,687)	53,707
	356,585	503,392	746,295
Uses:			
Additions to properties	744,475	713,149	714,413
Investments	23,010	19,569	1,623
Unamortized exchange on foreign debt	106,536	209,737	—
Working capital of previously consolidated subsidiary	—	15,855	—
Dividend	23,528	48,390	42,466
	897,549	1,006,700	758,502
Net used for operations	(540,964)	(503,308)	(12,207)
Provided from (used in) financing activities			
Issuance of long-term debt	597,060	132,140	124,207
Currency exchange adjustment	119,348	275,164	—
Reduction of long-term debt	(236,476)	(72,827)	(40,851)
Issuance of capital stock	—	18,200	101,800
Net provided from financing activities	479,932	352,677	185,156
Net increase (decrease) in cash during the year	(61,032)	(150,631)	172,949
Cash (Indebtedness), end of year	$ (152,719)	$ (91,687)	$ 58,944

*Excluding cash, current bank loans and other indebtedness, and current portion of long-term debt.

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

Note 1: Summary of Significant Accounting Policies

Introduction

All references in these Notes to the "Company" refer to Canadian National Railway Company which is wholly-owned by the Government of Canada and, unless the context otherwise requires, its consolidated subsidiaries, and all references to the "System" mean Canadian National Railway Company and its consolidated subsidiaries together with the lines of railway, marine, telecommunications and other property entrusted by the Government of Canada to the Company for management and operation.

a) Principles of Consolidation

The consolidated financial statements include the accounts of all subsidiaries except CN Marine Inc. and also include the Company's share of the assets, liabilities, revenues and expenses of CNCP Telecommunications which is accounted for by the proportionate consolidation method; CN's share in the activities of CNCP Telecommunications represents slightly less than 60 percent of the activities of CN Communications. Also, consistent with the legislation governing the System, the accounts of the Canadian Government Railways entrusted to the Company by the Government of Canada are included in the consolidated financial statements. Since, under Orders in Council issued in December 1984, control of CN Marine Inc. passed to the Government of Canada on January 1, 1985 and as it is intended that ownership thereof be transferred from CN to the Government, that company's accounts were deconsolidated effective January 1, 1984 and CN's investment in it was accounted for by the equity method for the year ended December 31, 1984 and by the cost method since that date.

Investments in companies in which the Company has less than a majority interest are accounted for by the equity method, where appropriate.

b) Reporting by Division

In presenting the results by division, charges for services performed by one division for another, which are made generally at market value, have not been eliminated. Consolidated net income is not affected by this practice.

c) Material and Supplies

The inventory is valued at laid down cost based on weighted average cost for ties and rails, latest invoice price for fuel and new materials in stores, and at estimated utility or sales value for usable second hand, obsolete and scrap materials.

d) Properties

Properties are carried at cost, which, in the case of properties brought into the System on January 1, 1923, is the aggregate of the values then appearing in the books of the railways now comprised in the System, less a write-down of $262.8 million at the time of capital revision in 1937.

Accounting for railway and telecommunications properties is carried out in accordance with rules issued by the Canadian Transport Commission and the Canadian Radio-television and Telecommunications Commission respectively (Canadian properties), and the Interstate Commerce Commission (United States properties). Generally, major additions and replacements are capitalized and interest costs are charged to expense.

The cost of depreciable railway and telecommunications assets retired or disposed of, less salvage, is charged to accumulated depreciation, in accordance with the group plan of depreciation. Other depreciable assets retired or disposed of are accounted for in accordance with the unit plan whereby gains or losses are taken into income as they occur.

The Company follows the successful efforts method of accounting for its oil and gas operations whereby the acquisition costs of oil and gas properties, the costs of successful exploratory wells and the costs of drilling and equipping development wells are capitalized.

Note 1: Summary of Significant Accounting Policies (Cont'd).

e) Depreciation

Depreciation is calculated at rates sufficient to write off properties over their estimated useful lives, generally on a straight-line basis. For railway and telecommunications properties, rates are authorized by the Canadian Transport Commission, the Canadian Radio-television and Telecommunications Commission and the Interstate Commerce Commission. The rates for significant classes of assets are as follows:

	Annual Rate
Ties	2.89%
Rails	1.87%
Other track material	1.90%
Ballast	2.76%
Road locomotives	5.23%
Freight cars	1.73% - 3.18%
Commercial communication systems	6.44%

Hotel properties are depreciated at annual rates of 2% to 10%.

Acquisition costs of oil and gas properties are amortized on a straight-line basis over the term of the lease until such time as they are determined to be productive or judged to be impaired. Acquisition costs of productive properties and costs of successful exploratory drilling and of drilling and equipping development wells are charged against income on the unit-of-production method based upon proven reserves of oil and gas. Exploratory dry hole and acquisition costs judged to be impaired are charged against income in the current period. Other exploratory expenditures are charged against income as incurred.

f) Transportation Revenues

Transportation revenues are generally recognized on completion of movements, with interline movements being treated as complete when the shipment is turned over to the connecting carrier. Costs associated with uncompleted movements are generally deferred.

g) Pensions

Current service costs are charged to operations as they accrue. Past service costs are charged to operations in annual amounts covering principal and interest over varying periods.

The funding payments are determined in accordance with the accrued benefit actuarial cost method.

h) Foreign Exchange

Effective January 1, 1984, the Company adopted prospectively the Canadian Institute of Chartered Accountants' recommendations for foreign currency translation. The financial statements and information related to periods prior to 1984 have not been restated for this change in accounting principle.

The Company's foreign operations are classified as integrated and are translated and accounted for on the following bases. Current assets (excluding material and supplies), current liabilities and long-term debt are translated at the rates in effect at the balance sheet date, whereas all other assets and liabilities are translated at historical rates. Revenues and expenses are translated at average rates during the year except for depreciation which is translated at exchange rates prevailing when the related properties were acquired.

The Company's own foreign denominated assets and liabilities are accorded similar treatment. Revenues and expenses are translated at rates prevailing at the time of the transactions except for revenues designated as a hedge against repayment of foreign denominated long-term debt which are translated at the hedge rates.

Currency gains and losses are reflected in net income for the year, except for unrealized foreign currency gains and losses on long-term debt. In conjunction with its adoption, effective January 1, 1984, of the Canadian Institute of Chartered Accountants' recommendations for foreign currency translation, the Company has designated future U.S. dollar revenue streams as a hedge against the repayment of long-term debt denominated in U.S. dollars, and has thus deferred reflecting the related unrealized foreign currency translation gains and losses in net income until the earlier of the debt repayment or the expiry of the hedge.

i) Leases

Leases which satisfy the criteria for capital leases and which have been entered into after 1981 have been capitalized. Other leases have been recorded as operating leases.

Note 2: Investments

December 31 (in thousands)	Percentage of Voting Interest	1985	1984
Entities accounted for by equity method:			
Chicago and Western Indiana Railroad Company	20%	$ 5,735	$ 5,916
CNCP Niagara-Detroit Partnership	50%	23,741	—
CN Marine Inc.*	100%	—	324,682
The Toronto Terminals Railway Company	50%	10,682	10,682
Other		10,793	15,894
		50,951	357,174
Subsidiary company accounted for by cost method:			
CN Marine Inc.*	100%	324,136	—
Other companies and investments, at cost less provisions for impairment where applicable			
Other		4,924	4,947
Total		$380,011	$362,121

*Effective January 1, 1985 the Company commenced accounting for this investment on the cost basis in accordance with the Government's assumption of direct control over its operations. The slight reduction in the carrying value was due to a dividend relating to fourth quarter 1984 activities having been received subsequent to December 31, 1984. Legislation required for the final divestiture of this investment has been tabled in Parliament.

Note 3: Properties

December 31 (in thousands)	1985			1984		
	Cost	Accumulated Depreciation	Net	Cost	Accumulated Depreciation	Net
Canadian Rail	$7,755,679	$2,766,643	$4,989,036	$7,284,859	$2,687,086	$4,597,773
TerraTransport	95,484	52,430	43,054	100,118	54,646	45,472
Grand Trunk Corporation	561,570	153,718	407,852	553,658	150,214	403,444
CN Route	95,284	55,257	40,027	105,630	56,472	49,158
Other Divisions						
CN Communications	708,538	288,916	419,622	709,762	281,943	427,819
CN Hotels	217,059	72,351	144,708	199,035	68,549	130,486
CN Exploration	74,947	12,211	62,736	41,731	5,264	36,467
CN Real Estate	72,750	18,221	54,529	66,261	17,812	48,449
Dockyard and Other	34,572	2,668	31,904	33,529	1,615	31,914
	$9,615,883	$3,422,415	$6,193,468	$9,094,583	$3,323,601	$5,770,982
Amounts included above with respect to Canadian Government Railways entrusted to the Company by the Government of Canada	$1,037,108	$ 556,142	$ 480,966	$ 982,132	$ 540,085	$ 442,047

At December 31, 1985 the gross value of assets under capital leases included above was $108.4 million (1984 – $51.3 million) and related accumulated amortization thereon amounted to $5.5 million (1984 – $4.0 million).

Note 4: Long-Term Debt

December 31	Maturity	Currency in which payable	1985	1984
				(in thousands)
Bonds, Debentures and Notes				
Canadian National 5¾%				
25 Year Bonds (a, b)	Jan. 1, 1985	Canadian	$ —	$ 63,211
Canadian National 8⅜%				
10 Year Bonds	Nov. 15, 1986	United States	83,232	83,232
Canadian National 8⅞%				
10 Year Bonds (b)	Mar. 1, 1987	Canadian	46,007	46,157
Canadian National 5%				
27 Year Bonds (a, b)	Oct. 1, 1987	Canadian	95,475	97,433
Canadian National 14⅛%				
10 Year Notes	Dec. 1, 1991	United States	117,817	117,817
Canadian National 11⅜%				
8 Year Notes	June 11, 1993	Canadian	100,000	—
Canadian National 12½%				
10 Year Notes	Apr. 15, 1995	Canadian	100,000	—
Canadian National 5¾%				
15 Year Swiss Franc Bonds (c)	Aug. 22, 2000	Canadian	98,617	—
Canadian National 9¼%				
20 Year Sinking Fund Debentures	Mar. 15, 1998	United States	115,729	124,631
Canadian National 8¾%				
25 Year Sinking Fund Debentures	July 1, 2002	United States	90,045	95,342
Canadian National 9.70%				
25 Year Sinking Fund Debentures	July 15, 2004	United States	174,940	174,940
Canadian National 13%				
20 Year Sinking Fund Debentures	Nov. 15, 2004	Canadian	100,000	100,000
Canadian National 12¼%				
20 Year Sinking Fund Debentures	May 1, 2005	Canadian	125,000	—
Canadian National 14%				
25 Year Sinking Fund Debentures	Jan. 15, 2006	United States	178,783	178,783
Canadian National 15%				
25 Year Sinking Fund Debentures	June 1, 2006	United States	181,238	181,238
Canadian National 16¼%				
25 Year Sinking Fund Debentures	Mar. 1, 2007	United States	183,053	183,053
Canadian National 14¾%				
30 Year Sinking Fund Debentures	Sept. 1, 2012	United States	247,984	247,984
Canadian National 12%				
30 Year Sinking Fund Debentures	Mar. 15, 2013	United States	122,548	122,548
Buffalo and Lake Huron 5½%				
1st Mortgage Bonds	Perpetual	Sterling	795	795
Buffalo and Lake Huron 5½%				
2nd Mortgage Bonds	Perpetual	Sterling	1,228	1,228
Total Bonds, Debentures and Notes			2,162,491	1,818,392
Government of Canada Loan and Advances (d)				
Government of Canada loan		Canadian	251,565	260,331
Canadian Government Railways advances for working capital		Canadian	14,004	14,075
Total Government of Canada Loan and Advances			265,569	274,406
Other				
Amounts owing under equipment purchase agreements (e)		United States	187,613	160,993
Swiss borrowings (f)		Swiss Francs	64,684	129,158
Syndicated loan (g)		Canadian	42,610	—
Capital lease obligations (h)		Various	99,405	42,509
Promissory note 9⅛% (i)		Canadian	1,116	1,423
Income debenture (j)		Canadian	8,065	8,243
Adjustment to current exchange rate (see Note 1h)			356,277	271,660
Total Other			759,770	613,986
			3,187,830	2,706,784
Less:				
Current portion of long-term debt			223,885	119,773
Other			15,598	14,398
			239,483	134,171
Long-Term Debt			$2,948,347	$2,572,613

Note 4: Long-Term Debt (Cont'd)

a) Guaranteed by the Government of Canada.

b) These bonds are subject to repurchase arrangements.

c) The Company borrowed $98.6 million at an all-inclusive cost of 11.17% by means of a public bond issue in Switzerland and a currency swap.

d) $204.7 million of the Government of Canada loan bears interest at 8¾% per annum and is payable in equal semi-annual payments of $13.63 million covering principal and interest to June 30, 1998. The balance is to be repaid in 1986 and has been included in the current portion of long-term debt. The weighted average interest rate on the $204.7 million loan and the advances outstanding at December 31, 1985 and 1984, was approximately 8.2% per annum.

e) Secured by rolling stock and payable by semi-annual or quarterly instalments over various periods to 1995 at interest rates ranging from 8% to 17¾%. As at December 31, 1985, the principal amounts are payable as U.S. $167.6 million (December 31, 1984 – U.S. $153.0 million).

f) A private placement of 100 million Swiss Francs bearing interest at 5⅛%, repayable on March 16, 1988, which is subject to earlier repayment at the Company's option.

g) The Company borrowed $42.6 million at an all-inclusive cost of 11.535% by means of a yen syndicated loan and currency swap.

h) Interest rates for these leases range from approximately 10¾% to 15¾% with expiry dates occurring during the years 1986 through 2004. The imputed interest on these leases amounts to $74.4 million (1984 – $44.4 million).

i) Repayable by semi-annual instalments of $218,503, including principal and interest, to August 1, 1988.

j) Payment of non-cumulative annual interest at 16.55% and repayment of principal during the term and at maturity of the debenture in 2008 is conditional on the annual financial results of one of the Company's operations.

k) Principal repayments, including sinking fund repayments and repurchase arrangements, on debt outstanding at December 31, 1985, are as follows:

Year ending December 31:	(in thousands)
1986	$223,885
1987	208,422
1988	164,694
1989	76,707
1990	79,165
1991 – 1995	975,175
1996 – 2000	687,980
2001 – 2005	529,260
2006 – 2010	139,131
2011 – 2013	67,118

Note 5: Shareholder's Equity

Retained Earnings

Under its governing legislation, the Company is required to pay to the Receiver General for Canada a dividend equal to 20% of net income for the year or such greater percentage as the Governor in Council may direct. Accordingly, a dividend representing 20% of the net income for the year has been accrued and is included in Other current liabilities.

Note 6: Major Commitments

a) Leases

(i) The Company's commitments as at December 31, 1985, under leases, excluding those which have been capitalized and for which the lease obligations are recorded as long-term debt (see Note 4), are as follows:

Non-Cancellable Leases	Capital Leases	Operating Leases
Year ending December 31:		
(in thousands)		
1986	$ 46,956	$ 67,520
1987	45,112	64,171
1988	41,918	58,420
1989	33,751	52,318
1990	14,009	31,914
1991 – 1995	16,093	117,141
1996 – 2000	3,942	38,038
thereafter	1,326	5,874
Total minimum lease payments	203,107	$435,396
Less amount representing imputed interest	45,228	
Present value of net minimum lease payments under capital leases	$157,879	

A significant portion of the leases is in respect of railway rolling stock and many of them provide renewal options and an option to purchase the property at fair market value at the end of the lease term.

(ii) Rental expenses under all lease arrangements were:

Year ended December 31	1985	1984	1983
(in thousands)			
Total expenses	$187,949	$197,041	$169,328
Expenses under capital leases not included in long-term debt	$ 50,863	$ 49,380	$ 46,899

(iii) Increases in income, assets and liabilities in the consolidated financial statements, which would have arisen if leases entered into prior to 1982 and which satisfied the criteria for capital leases had been capitalized, are as follows:

Year ended December 31	1985	1984	1983
(in thousands)			
Net increase in income	$ 10,776	$ 3,036	$ 2,272
Increase in Assets			
Properties			
Leased properties under capital leases	$293,865	$293,825	$295,782
Less accumulated amortization	212,108	193,172	172,959
	81,757	100,653	122,823
Other assets and deferred charges			
Unamortized deferred exchange loss	17,689	23,323	—
	$ 99,446	$123,976	$122,823
Increase in Current Liabilities			
Present value of obligations under capital leases	$ 33,387	$ 33,954	$ 28,500
Increase in Non-Current Liabilities			
Present value of obligations under capital leases	$127,180	$154,832	$186,288
Adjustment to current exchange rate (see Note 1 h)	30,699	31,097	—
	157,879	185,929	186,288
Less current portion	33,387	33,954	28,500
	$124,492	$151,975	$157,788

b) Other

The Company has commitments at December 31, 1985, for capital expenditures of $38.5 million for railway ties and $38.6 million for rolling stock.

Note 7: Subsidies

Revenues include the following subsidies:

Year ended December 31	1985	1984	1983
(in thousands)			
Government of Canada			
a) Payments under the Railway Act paid under authority of that Act and the related Appropriation Act in respect of certain uneconomic operations, services and prescribed rates which railways are required by the Railway Act to maintain	$ 37,151	$ 48,762	$205,468
b) Interim payments to partially offset revenue shortfalls associated with the cost of carrying grain at uneconomic statutory rates	—	8,660	228,452
c) Maritime Freight Rates Act and Atlantic Region Freight Assistance Act subsidies	20,460	20,727	17,361
d) Sundry	6,074	2,433	6,154
Other	167	168	168
	$ 63,852	$ 80,750	$457,603

Note 8: Pensions

The Company has retirement benefit plans covering substantially all its employees under which they are entitled to benefits at retirement age generally based on compensation and length of service and/or contributions. Annual pension costs were as follows:

Year ended December 31	1985	1984	1983
(in thousands)			
	$ 139,956	$ 167,156	$ 138,252

In 1985, the Company reviewed the causes of the past excess of charges to operations over funding requirements and revised the amortization schedule to reflect an improved systematic pattern for recognizing past service costs. This revision resulted in a deferral of pension costs to future years, with the deferral in respect of 1985 being $21 million. Also, the effect of the most recent actuarial valuations reduced 1985 pension costs by $58.6 million (1984 – $46.4 million, 1983 – $47.1 million).

The total amount of past service costs remaining to be charged to operations at December 31, 1985, 1984 and 1983 based on the latest actuarial valuation at the time and adjusted for subsequent changes, aggregate:

At December 31	1985	1984	1983
(in thousands)			
Canadian plans	$1,528,639	$1,480,297	$1,415,981
U.S. plans	13,281	13,347	13,682
	$1,541,920	$1,493,644	$1,429,663

The past service costs relating to the Canadian plans at December 31, 1985 will be charged to operations in annual amounts, including principal and interest, as follows:

	Annual Cost		Annual Cost
(in thousands)			
1986	$128,761	1997	$133,783
1987	128,924	1998	132,580
1988	127,365	1999	135,806
1989	127,666	2000	146,774
1990	128,681	2001	154,847
1991	134,913	2002	163,364
1992	141,438	2003	172,349
1993	124,271	2004	181,828
1994	126,703	2005	191,828
1995	133,342	2006	202,379
1996	134,600		

The major portion of the past service costs relating to the U.S. plans at December 31, 1985 will generally be amortized at an annual rate of $1.7 million including principal and interest to 1993 inclusive.

For the year 1985 funding exceeded the charge to operations by $88.5 million whereas in 1984 and 1983, charges to operations exceeded funding by $36.6 million and $25.4 million respectively. The cumulative excess of charges to operations over funding requirements amounts to $29.7 million (1984 – $118.2 million) and is included in Other Liabilities and Deferred Credits.

Note 9: System Interest Expense

Year ended December 31	1985	1984	1983
(in thousands)			
Interest			
Total interest on long-term debt	$333,574	$281,097	$274,180
Amortization of foreign exchange on long-term debt*	—	65,427	—
Interest on short-term borrowings	5,381	15,907	7,950
Interest on investments	(2,713)	(13,320)	(13,687)
Total interest (net)	$336,242	$349,111	$268,443

*Pursuant to the hedging of foreign currency long-term debt (Note 1h), the reduction of the deferred foreign exchange loss, which in 1985 amounted to $12.8 million, has been shown as a reduction of Canadian Rail revenues.

Note 10: Income Taxes

a) The Company has timing differences of approximately $310 million which are available to reduce taxable income of future years. Of that amount, about $62 million is due to the excess of the undepreciated capital cost for income tax purposes over net book value of depreciable assets.

b) Investment tax credits are also available to reduce future income taxes otherwise payable until the related year of expiry:

Year of Expiry	(in millions)
1986	$35.0
1987	32.0
1988	4.2
1990	25.7
1991	33.6
1992	26.0

The Company is eligible for a refund of 20% of the current year's investment tax credits in respect of qualified expenditures and has recognized the resulting benefit as a reduction of such expenditures.

c) The Company's provision for income taxes is made up as follows:

Year ended December 31	1985	1984	1983
(in thousands)			
Provision for income taxes based on combined basic Canadian federal and provincial tax rate of 48.9% (1984 – 48.0%, 1983 – 48.6%)	$57,752	$116,325	$103,149
Increase (decrease) in taxes resulting from:			
Non-allowable scientific research expenditures, net of proceeds from sale of related tax credits	—	5,469	—
Refundable investment tax credits	—	(4,224)	(3,062)
Profit on sale of land	(2,437)	(4,076)	(2,221)
Other	2,508	3,629	1,424
Actual provision for income taxes resulting in an effective tax rate of 49.0% (1984 – 48.3%, 1983 – 46.9%)	$57,823	$117,123	$ 99,290

Note 11: Segmented Information

a) Geographic Areas

Virtually all of the System's operations and assets are within Canada with the exception of Grand Trunk Corporation which operates in the United States.

b) International Traffic

In addition to the revenue generated by Grand Trunk Corporation, the System derives revenue from traffic originating or terminating on railroads in the United States. In 1985, such revenues approximated $628 million (1984 – $662 million, 1983 – $581 million).

c) Identifiable Assets by Division

December 31 (in thousands)	1985	1984	1983
Canadian Rail	$6,496,422	$5,887,685	$4,996,742
TerraTransport	56,906	60,326	57,901
Grand Trunk Corporation	633,296	605,774	591,851
CN Route	76,493	92,513	90,564
Other Divisions			
CN Communications	498,873	502,858	471,750
CN Hotels	179,954	163,682	138,783
CN Exploration	73,401	42,522	31,111
CN Real Estate	81,982	69,140	57,720
Dockyard and Other	41,454	42,111	44,160
CN Marine Inc.*	—	—	309,183
Total assets per Consolidated Balance Sheet	$8,138,781	$7,466,611	$6,789,765

d) Capital Expenditures and Depreciation by Division

Year ended December 31 (in thousands)	Capital Expenditures**			Depreciation		
	1985	1984	1983	1985	1984	1983
Canadian Rail	$594,303	$597,270	$508,690	$196,297	$184,416	$167,556
TerraTransport	3,037	2,912	1,202	5,443	5,237	4,044
Grand Trunk Corporation	20,903	18,231	11,264	13,593	12,772	13,366
CN Route	925	8,223	8,164	5,490	5,741	7,524
Other Divisions						
CN Communications	64,658	54,061	45,631	46,192	42,323	40,679
CN Hotels	20,562	14,728	5,074	6,219	5,725	5,748
CN Exploration	33,283	16,987	15,216	6,994	2,992	2,028
CN Real Estate	5,687	231	10,747	1,026	709	637
Dockyard and Other	1,117	506	8,736	1,065	1,035	822
CN Marine Inc.*	—	—	99,689	—	—	11,602
	$744,475	$713,149	$714,413	$282,319	$260,950	$254,006

* See Note 1 a).

** Represents additions to property, plant and equipment.

Note 12: Other Matters

a) The Company carries on ordinary business transactions with various entities controlled by the Government of Canada on the same terms and conditions as current transactions with unrelated parties.

In addition, the Company provides, under contractual arrangements, rail transportation and maintenance services to the Government of Canada and to entities controlled by the latter. The revenue derived from such services rendered in 1985 aggregated $320.0 million (1984 – $351.8 million, 1983 – $444.8 million).

b) Commencing in 1977, the Government of Canada has agreed to pay to the Company, by way of capital grants not exceeding $557.9 million, certain amounts with respect to expenditures incurred in carrying out rehabilitation programs for branch lines in Western Canada. Total payments received up to December 31, 1985, amounted to $396.9 million of which $43.7 million was received in 1985 (1984 – $64.8 million).

c) As part of a program commenced in 1981 for the testing and evaluation of railway operations in Newfoundland, the Government of Canada reimbursed CN for certain wage and wage-related costs. Total billings under this program amounted to $7.6 million in 1985 (1984 – $4.1 million).

Note 13: Reclassification of Comparative Figures

During 1985, changes were made to improve the classification of certain items and for comparative purposes the 1984 and 1983 figures have been reclassified. The major change was the combining under "Canadian Rail" of the former CN Rail Division with the Corporate group, whose results, together with the interest not allocated to divisions, had previously been designated as "Miscellaneous" in the Consolidated Statement of Income. Coincidentally, a more complete assignment of interest and other miscellaneous costs to the divisions was made.

Auditors' Report

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Canada H3B 1W5

To The Minister of Transport
Ottawa, Canada

We have examined the consolidated balance sheets of the Canadian National Railway System as at December 31, 1985 and 1984 and the consolidated statements of income, retained earnings and changes in financial position for each of the years in the three year period ended December 31, 1985. Our examinations were made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the System as at December 31, 1985 and 1984 and the results of its operations and the changes in its financial position for each of the years in the three year period ended December 31, 1985 in accordance with generally accepted accounting principles applied, except for the change in the method of accounting for foreign exchange translation in the year ended December 31, 1984 as set out in Note 1 h) to the consolidated financial statements, on a consistent basis.

Also, in our opinion, the transactions that have come to our notice in the course of our examination have been within the powers of the System.

Touche Ross & Co.

Chartered Accountants
(For the year ended
December 31, 1985)

Montreal, Quebec
February 24, 1986

Coopers & Lybrand

Chartered Accountants
(For the years ended
December 31, 1985, 1984 and 1983)

Montreal, Quebec
February 24, 1986

Supplementary Information Regarding the Effects of Changing Prices (Unaudited)

The financial statements presented in this Annual Report are based on historical prices established in transactions to which the Company was a party. Financial statements prepared on this basis continue to be needed since changes in shareholder's equity in the long run depend on actual transactions and because historical prices based on these transactions generally are the result of arm's length bargaining and provide an objective measure of results that is independently verifiable.

Nevertheless, prolonged periods of significant inflation have resulted in increasing recognition of limitations in the usefulness of conventional historical cost financial statements and of a need for some disclosure about the impact of inflation on the financial position and operating results. Consequently, as recommended by the Canadian Institute of Chartered Accountants (CICA) the Company has set forth supplementary information designed to provide the reader with some insight on the extent to which the Company's capital has been maintained in the inflationary environment.

The CICA recommendations recognize two possible concepts for determining whether the capital has been maintained. The first is the maintenance of operating capability concept, which holds that capital is maintained when the assets of the enterprise remain sufficient to continue the previous level of services. A further refinement of this concept recognizes the extent to which the assets have been financed with borrowed funds and is concerned with the maintenance of the common shareholders' proportionate interest in the operating capability of the entity. The second is the maintenance of financial capital concept which requires that the money amount of the net assets of the company must remain intact.

The elements of the net loss attributable to the shareholder on a current cost basis under an operating capability concept of capital and the items included in Other Supplementary Information disclosed in the 1984 Annual Report have been restated in 1985 average dollars whereas the 1984 current cost figures for properties and net assets have been restated in December 1985 dollars.

Under either concept, the effect of changing prices is determined by using current costs which represent the amount of cash or other consideration that would be needed currently to acquire an asset having the same service potential as embodied by the asset owned. The Company has applied this approach to properties and related depreciation. Using current costs, the properties would be increased by $16,880,826,000 in 1985 (1984 – $17,713,741,000) when compared to their historical cost measured in nominal dollars. Similarly, depreciation for 1985 based on the average current cost of the properties for 1985 would be higher than depreciation based on the historical cost of the properties, by $665,624,000 in 1985 (1984 – $630,750,000). The major explanation for this difference is that many of the Company's properties are old but can still be used because of their long economic life.

The accompanying statement is based on the maintenance of operating capability concept. In addition to the increased depreciation, it includes a financing adjustment which indicates the extent to which increases in the current cost amounts of assets during the year do not, on the basis of the existing relationship between debt and equity, need to be charged against present and future revenues to ensure maintenance of the common shareholder's proportionate interest in the operating capability.

It should be understood that much remains to be learned about reporting the effects of changing prices and a complete assessment of the usefulness of this supplementary information will only be possible after an extended period of preparing and using it. The CICA has recognized that its recommendations do not deal with all practical problems that may be encountered and consequently has provided for flexibility and experimentation in applying them and is planning a comprehensive review of them by 1988. These limitations should be recognized in using the supplementary information. In particular, it should not be interpreted as an indication that the Company intends to replace particular assets or that the costs presented represent the costs that would be incurred if the assets were replaced. Therefore, this information should not be used in evaluating the Company's performance until a sufficient period of experimentation has elapsed and conclusive evidence has been obtained regarding its appropriateness.

On the current cost basis the Company incurred a loss in both 1984 and 1985, as compared with a reported income on the historical cost basis. This is mainly due to the higher annual depreciation recognized on the current cost basis. While there can be some question regarding the absolute amounts, it points up the general problem of financing new and replacement assets in an environment which has been affected by the ravages of inflation. In responding to this situation, CN must seek a full commercial return on its services, which return must reflect the cost of maintaining its operating capability. At the same time, management must continue to take full advantage of advances in technology to control the level of future capital and operating expenditures. Over and above this, while there has been increasing recognition by Governments of the need to control inflation, the availability of information regarding the impact of changing prices on enterprises should exert a positive influence on their formulation of economic policies, including taxation.

Consolidated Statement of Income Adjusted to the Current Cost Basis Under an Operating Capability Concept of Capital

Year ended December 31	1985	1984
(Unaudited) (in thousands)		(Indexed)
Net income on an historical cost basis	$ 117,639	$ 251,645
Depreciation adjustment	(665,624)	(630,750)
Financing adjustment	101,840	88,305
Net loss attributable to the shareholder on a current cost basis under an operating capability concept of capital	$ 446,145	$ 290,800

The financing adjustment was based on the current cost adjustment for depreciation made to income. Alternatively, had the financing adjustment been based on the changes in the current cost of properties during 1985 it would have amounted to $167,526,000 (1984 – $140,586,000) and the net loss attributable to the shareholder on a current cost basis under an operating capability concept of capital would have been reduced by $65,686,000 (1984 – $52,281,000).

Other Supplementary Information

Year ended December 31	1985	1984
(Unaudited) (in thousands)		(Indexed)
Increase in current cost of properties	$1,094,941	$1,104,664
Effect of general inflation	971,997	848,508
Excess of increase in current cost over the effect of general inflation	$ 122,944	$ 256,156
Gain in general purchasing power from having net monetary liabilities	$ 153,570	$ 122,463

Schedule of Assets on a Current Cost Basis

December 31	1985		1984	
	Historical Cost Basis	Current Cost Basis (Unaudited)	Historical Cost Basis	Current Cost Basis (Unaudited and Indexed)
(in thousands)				
Properties	$6,193,468	$23,074,294	$5,770,982	$23,484,723
Net assets (shareholder's equity)	$3,418,451	$20,299,277	$3,324,340	$20,931,618

The above amounts reflect estimated current costs. There is a continuing need for development of the methods used in determining these costs and we expect to continue our efforts in this regard. The following notes provide a general description of the methods followed in 1985.

Notes to Supplementary Information Regarding the Effects of Changing Prices

Note 1: Bases and Methods Used in Determining Current Cost Information

a) Ties

The average current cost per tie applied to the total quantity of ties was obtained by applying the appropriate index to the aggregate of the recent current average purchase price for untreated ties and the average treatment cost per tie.

b) Rails

The average current cost per ton applied to the tonnage of rail was determined by applying the appropriate index to invoice prices and increased by an estimate for welding costs.

c) Other Track Material and Ballast

The current cost of other track material and ballast was determined by using estimates of direct prices.

d) Grading, and Road Locomotives and Freight Cars including those under Capital Leases

The current cost of grading, and road locomotives and freight cars including those under capital leases, was determined by applying the appropriate indices obtained from Statistics Canada and the Association of American Railroads.

e) Commercial Communications Systems

There are several sub-categories under this class and for each category the most practical pricing technique has been used in determining current cost. Pricing tehniques used include indexing based on indices produced by the Company and Statistics Canada as well as reference pricing and direct pricing.

f) Land and Buildings

The current cost of land is the estimated value determined by appraisals primarily using the "market value for existing use" approach. The current cost of buildings was obtained by applying the appropriate index to recently estimated construction costs for buildings with similar service potential.

g) Construction in Progress

The historical cost of assets which are currently being constructed and are not yet in service approximates their current cost and is included in the current cost information.

h) Donations and Grants

The current values for donations and grants were based on the methods employed for the related asset costs.

i) Depreciation Expense

Current cost depreciation expense was calculated by reference to the average current cost of properties.

Note 2: Significant Items not Presented on a Current Cost Basis

a) Material and Supplies

The material and supplies inventory is used by the Company and is not normally available for resale. The amount reported in the historical cost financial statements approximates the amount that would be required to acquire similar items on a current basis.

b) Unrecorded Capital Leases

In accordance with the transitional provisions regarding lease accounting, financial information related to capital leases entered into prior to 1982 is disclosed in Note 6 to the financial statements. Such information has not been presented on a current cost basis.

Canadian National Railways Pension Trust Fund Consolidated Statement of Financial Position as at December 31

(in thousands)	1985	1984
Investments		
Bonds – quoted market value 1985 – $2,334,803; 1984 – $1,768,735	$2,130,070	$1,744,902
Mortgages	267,730	293,580
Real estate	287,675	187,761
Oil and gas	116,446	67,604
Equities – quoted market value 1985 – $1,905,456; 1984 – $1,561,107	1,154,649	1,169,307
Short-term investments	183,891	218,541
	4,140,461	3,681,695
Cash	973	1,408
Accounts receivable – Canadian National Railways	8,359	7,584
Accrued interest and other assets – net	42,169	58,561
	4,191,962	3,749,248
Amount to be funded		
Amount to be funded by the Company in accordance with the Pension Benefits Standards Act by special payments to December 31, 2006		
Balance, beginning of year	1,598,485	1,497,620
Add increases during year	33,084	115,810
Deduct principal payments	(37,321)	(14,945)
Balance, end of year	1,594,248	1,598,485
	$5,786,210	$5,347,733

See accompanying notes to consolidated statement of financial position.

Auditors' Report

To The Minister of Transport,
Ottawa, Canada

We have examined the consolidated statement of financial position of the Canadian National Railways Pension Trust Fund as at December 31, 1985. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, this consolidated financial statement presents fairly the financial position of the Canadian National Railways Pension Trust Fund as at December 31, 1985 and the results of its operations for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Also, in our opinion, proper books of account have been kept and the transactions that have come under our notice have been within the powers of the Trustee.

Mallette, Benoit, Boulanger, Rondeau & Associés

Mallette, Benoit, Boulanger, Rondeau & Associés
Chartered Accountants
Montreal, February 21, 1986

(in thousands)	1985	1984
Actuarial Liability for Pension Benefits		
Balance, beginning of year	$5,347,733	$4,920,022
Additions during year		
Increases in actuarial liability for pension benefits resulting from		
— Actuarial valuation	6,665	—
— Increases in pension benefits and actuarial liability related to current service	26,419	115,810
	33,084	115,810
Contributions by employees on account of		
— Current service	83,969	89,059
— Prior years' service	9,710	7,873
	93,679	96,932
Contributions by the Company	225,869	128,722
Net earnings on investments	430,756	383,590
	750,304	609,244
	6,131,121	5,645,076
Deductions during year		
Pension benefits	298,508	273,343
Refunds and settlements on termination of service and reduction in actuarial liability on transfers	9,082	9,055
Principal payments applied to amount to be funded	37,321	14,945
	344,911	297,343
Balance, end of year	$5,786,210	$5,347,733

On behalf of the Board:
J. Maurice LeClair, Director
Ronald E. Lawless, Director

Actuarial Certificate

To the Trustee
Canadian National Railways Pension Trust Fund

I have examined the actuarial liability for pension benefits shown in the consolidated statement of financial position of the Canadian National Railways Pension Trust Fund as at December 31, 1985, and in my opinion the amount of $5,786,210,000 represents an adequate estimate of the actuarial liabilities for all pension benefits of the 1935 and 1959 Pension Plans and of the Northern Alberta Railways Company Pension Plan. This amount is based on our latest actuarial valuations which were conducted in accordance with generally accepted actuarial principles and assumes no experience gains or losses have arisen since such valuations.

Bernard Morency
Fellow of the Canadian Institute of Actuaries

William M. Mercer Limitée
Montreal, February 14, 1986

Note 1: Summary of Significant Accounting Policies

a) Pension Plans of Canadian National Railways covered by Statement

The Pension Trust Fund consolidated statement of financial position includes the actuarial liability for pension benefits, the investments and the amount to be funded with respect to the 1935 and 1959 Pension Plans and to the Northern Alberta Railways Company Pension Plan.

These plans under which benefits are generally based on compensation and length of service and/or contributions cover substantially all employees of the Canadian National Railway System.

b) Consolidation of Wholly-owned Companies

The Pension Trust Fund has invested in a number of wholly-owned companies. The accounts of these companies are consolidated with the accounts of the Pension Trust Fund.

c) Investment Valuation

(i) Bonds are carried at their amortized cost, plus deferred amounts arising from exchanges made to improve yields which are written-off over the remaining life of the bonds sold;

(ii) Mortgages are carried at outstanding principal balances and are secured by real estate;

(iii) Real estate consists of land, buildings, and equities. Land is carried at the lower of cost and net realizable value less encumbrances, and buildings at the lower of cost and net realizable value less encumbrances and accumulated depreciation calculated using the sinking fund method, and equities amounting to $147.0 million in 1985 (1984 — $0.8 million) at cost. The quoted market value of these equities was $148.9 million in 1985 (1984 — $0.8 million);

(iv) Oil and gas properties are carried at cost as determined by the full cost method less depletion except that for properties managed by Dome Petroleum Limited no depletion is provided for as the Fund holds an offer to purchase, effective until January 3, 1999, which it may exercise for a consideration equal to their cost less proceeds on disposal of any portion of such properties;

(v) Equities and short-term investments are carried at cost;

(vi) The quoted market value of investments in bonds and equities is based on the closing market quotations as of December 31.

d) Determination of Contributions by the Company

In respect of the 1959 and the Northern Alberta Railways Company Pension Plans, the contributions by the Company are determined in accordance with the accrued benefit actuarial cost method using a projection of salary. In the case of the 1935 Pension Plan, the Company matches some of the members' contributions as determined by the rules of the plan and pays a level rate of contribution actuarially determined using the entry age normal actuarial cost method.

The latest actuarial valuation for the 1935 and 1959 Pension Plans was as at December 31, 1984 and as at December 31, 1983 for the Northern Alberta Railways Company Pension Plan.

The principal assumptions adopted by the Plans' actuary for purposes of the actuarial computations are members' mortality, disability, retirement, termination of employment, merit and periodic increases in earnings, as well as a long-term rate of return of 7% per annum on investments. Future increases in members' earnings have been projected using economic assumptions consistent with this long-term rate of return.

The contributions by the Company meet the requirements of the Pension Benefits Standards Act and regulations thereunder. Consistent with the regulations, the Company is making annual special payments over varying periods to 2006.

e) Accounting for Contributions

Contributions from employees are recorded in the period in which the Company makes payroll deductions.

The contributions by the Company are determined in accordance with the requirements of the Pension Benefits Standards Act and the regulations thereunder and are recorded using the accrual method.

f) Income Determination

Dividend income is recorded as of the ex-dividend date. Income from other investments is recorded as earned on an accrual basis.

Gain or loss on sales of equities is based on the average cost.

g) Foreign Exchange

Investments denominated in foreign currencies other than short-term investments are translated at historical rates of exchange. Short-term investments and the quoted market value of investments denominated in foreign currencies are translated at current rates. Foreign dividends and interest income are translated at the rates prevailing when received.

Note 2: Subsequent Event

During 1985, many CN employees transferred to VIA Rail Canada Inc. and CN Marine Inc. Also, CN Hotels and CN Exploration each established their own separate pension plans which now apply to employees who were formerly members of Plans covered by the Canadian National Railways Pension Trust Fund. As a result of these changes, it is contemplated that the membership of these employees will be terminated and based on data as at December 31, 1984, the total actuarial liability will be reduced by approximately $163 million with an appropriate reduction in the investments and the remaining amount to be funded.